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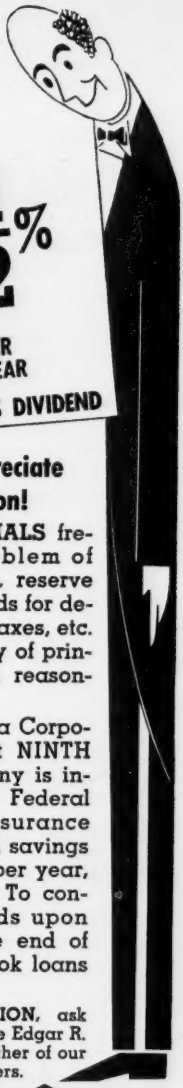

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VOL. XXII *February • 1952* NO. 2

Tax Decisions of 1951

By JACK SCHLOSSER, C.P.A.

THE field of taxation has, during the year 1951 and the period immediately preceding it, received marked legislative attention, overshadowing to some extent the work of the courts. Thus, during that period of time, we were deluged by the Revenue Act of 1950, the Excess Profits Act of 1950 and, finally, the Revenue Act of 1951. Nevertheless, a selective study of 1951 court decisions should prove of some value to most tax and accounting practitioners.

Split-up of Income

Because of the $25,000 corporate surtax and excess profits tax exemptions and in view of the sharply graduated individual surtax rates, there is a constant incentive for taxpayers to attempt to reduce their tax liability by increasing the number of reporting taxpayers. This past year saw its full quota of cases on this subject, with varying results.

JACK SCHLOSSER, C.P.A., is a member of our Society and of its Committee on State Taxation.

He was graduated from The City College (New York) School of Business and Civic Administration in June 1939, with the degree of B.B.A.

Mr. Schlosser is a partner in the firm of Eisner and Lubin, CPA's.

Where one corporation operated five wholesale grocery units in five different cities, reorganized in 1944, and formed five separate corporations, it was allowed individual excess profits tax exemptions for each entity. The court held that section 129 did not apply because of the following business purposes for the reorganization:

(1) Split-up increased over-all borrowing power under local banking laws, which increased power was utilized.

(2) To permit handling of competitive merchandise lines available only on an exclusive franchise basis.

(3) To limit tort liability because of difficulty in obtaining tort liability insurance locally.

(*Alcorn Wholesale Co., et al.*, 16 T.C. 75; Jan. 17, 1951, Acq.)

The same conclusion was reached where a corporation operating 51 retail shoe branches incorporated 22 of them into separate corporations. The court found that the tax savings motive was only incidental to the desired realignment of liability under store leases.

(*Berland's, Inc., of South Bend, et al.*, 16 T.C. 182; Jan. 25, 1951, Acq.)

Petitioner manufactured fans and blowers and sold its products through its own officers and through independent sales agents. In 1944 three separate sales corporations were formed.

Their stockholders were essentially the same as the stockholders of the taxpayer. These three affiliates sold only petitioner's products. The court ruled that section 45 was entirely inapplicable. It held further that section 129 could not be invoked because of the following business purposes:

(1) To reduce liability for injuries from use of products.

(2) To save in freight charges by establishing assembly plants in the territory of ultimate sale.

(3) To increase sales through operation of companies located in separate territories.

(*Chelsea Products, Incorporated,* 16 T.C. 840; Apr. 19, 1951; appealed.)

On the other hand, where a corporation paid commissions to a newly-formed partnership consisting of three of its officer-stockholders and three of its salesmen, the Commissioner successfully contended that the compensation thus paid was not deductible under either Section 45 or Section 22(a) of the Code.

(*Sidney Kocin* v. *U. S.,* (C.C.A.-2) Mar. 12, 1951.)

A Tennessee corporation formed a Mississippi subsidiary to operate a branch in the latter state in order to overcome the disadvantages of a foreign corporation operating in Mississippi. Based upon the foregoing, the court refused to permit the Commissioner to combine their separate net incomes.

(*J. E. Dilworth Company* v. *Henslee,* U. S. District Court, Tennessee; July 27, 1951.)

Where the principal stockholder of a corporation assumed its sales and engineering functions, leaving it engaged solely in the manufacturing process, the subdivision of income was recognized and accepted by the court. The court found that the charge for services rendered by the stockholder to the corporation was reasonable.

(*Estate of Julius I. Byrne,* 16 T.C. 1234; May 31, 1951.)

Another favorable decision on this issue was issued in *L. W. Tilden Inc.* v. *Commissioner* (C.C.A.-5), Nov. 23, 1951, while the taxpayer received a split decision in *Grenada Industries Inc., et al.,* 17 T.C., No. 28; Aug. 22, 1951.

Another method of splitting income, in common use and hence frequently encountered in the courts, is the leasing of property by related taxpayers. During 1951 the following decisions on this issue were released:

Taxpayer corporation sold part of its machinery to a partnership composed of its sole stockholders and immediately leased it back. The corporation had the exclusive right to rent and an option to purchase upon termination of the partnership. The court held that the transaction was wholly without substance and disallowed the rent in full.

(*Shaffer Terminals, Inc.,* 16 T.C. 356; Feb. 16, 1951.)

Similar results were arrived at in *58th Street Plaza Theatre, Inc.;* 16 T.C. 469—Feb. 27, 1951, and *W. H. Armston Company, Inc.,* v. *Commissioner* (C.C.A.-5), Apr. 25, 1951. The double danger implicit in this type of arrangement is illustrated in both of these decisions, where the disallowed rent was nevertheless taxed to the recipient as a dividend.

On the other hand, where the related taxpayer's right to the rented property does not grow out of a sale or gift followed by a leaseback, generally the rent will be recognized, but only to the extent considered reasonable. Furthermore, changes in existing lease terms will be scrutinized closely and even suspiciously.

(*Roland F. Place,* 17 T.C., No. 23; Aug. 10, 1951; *Stanwick's* v. *Commissioner,* (CCA-4) June 25, 1951; *Manos Amusements, Inc.,* Tax Court Memo Decision, Aug. 9, 1951 (appealed); *Estate of Frederick N. Sullivan, Sr.,* Tax Court Memo Decision; Aug. 10, 1951.)

Purchase of Stock to Acquire Assets

Corporations desiring to acquire assets owned by another corporation are often required to purchase the latter's stock rather than the assets in question because of tax considerations on the part of the sellers. In 1951 the Fifth Circuit upheld the Tax Court's prior finding that the acquisition of stock of another corporation and its subsequent liquidation were parts of a single transaction, i.e., the purchase of the liquidated corporation's assets.

The basis of the assets to the purchasing corporation was deemed to be the cost paid therefor and not the basis of the liquidated corporation. In other words, the Court recognized the realities of the situation and did not rely on strict legalities to restrict the purchaser's basis.

(*Kimbell-Diamond Milling Company*, (CCA-5) March 16, 1951.)

Claims for Refund

Claims for refund should be carefully and completely prepared. The dangers of faulty preparation were vividly illustrated by two 1951 decisions:

A corporation which based its claim for refund of undistributed profits tax on section 26(f) of the 1936 Revenue Act was not entitled to have the Court consider a refund under section 26 (c)(3), which was not referred to in the refund claim.

(*Nemours Corporation* v. *U. S.*, (CCA-3) April 19, 1951; cert. den., Oct. 8, 1951.)

A claim for refund was based upon the grounds that taxpayer's spouse was his *partner*. The court found that under state law she could not be a partner but could be and was a *co-venturer*. Nevertheless, the claim was rejected because it was not based upon the existence of a joint venture.

(*Victor T. Schaefer, Jr.* v. *U. S.*, U. S. District Court, Hawaii; June 22, 1951.)

Interest

Where a deficiency is *unassessed* and is wiped out by the allowance of a section 722 claim, the interest on said potential deficiency is similarly eliminated.

(*Henry River Mills Company* v. *U. S.*, U. S. Court of Claims; April 3, 1951.)

On the other hand, where a deficiency is *assessed* and then subsequently eliminated by an unused credit carryback, the interest on that original deficiency remains due and payable.

(*De Soto Hardwood Flooring Co., Inc.*, v. *U. S.*, U. S. District Court, Tennessee; Dec. 20, 1950.)

Penalties

The penalty for failure to file either a personal holding company or excess profits tax return was *not* imposed when the taxpayer made all of the pertinent data available to and relied upon a competent tax adviser. That adviser could be either an accountant or a lawyer.

(*Watkins Patents, Inc.*, Tax Court Memo Decision—Nov. 30, 1950; *Heil Beauty Supplies, Inc.*, Tax Court Memo Decision—Dec. 13, 1950; *Electroline Sales Company*, Tax Court Memo Decision—Jan. 30, 1951; *Plastic Parts Development Corp.*, Tax Court Memo Decision—June 18, 1951.)

On the other hand where the tax adviser obviously failed to consider the question at issue or made an inadequate investigation into it, the penalty was imposed.

(*Simone Corporation*, Tax Court Memo Decision; Jan. 25, 1951.)

Where pertinent information was not given by the client to the accountant, the penalty for failure to file a personal holding company return was levied.

(*Burton Swartz Land Corporation*, Tax Court Memo Decision—Jan. 25, 1951; appealed.)

A negligence penalty for omission of income was not eliminated when the tax for that year was eliminated by a loss carryback.

(*C. V. L. Corporation*, 17 T.C., No. 95; Nov. 23, 1951.)

O.P.A. Penalty Payments

Payments to the Office of Price Administration because of violations made intentionally and knowingly are not deductible.

(*National Brass Works, Incorporated,* 16 T.C. 1051—May 15, 1951; appealed.)

Where, however, the taxpayer overcharged customers without wilfulness, intention, or carelessness, payments to the Office of Price Administration were deemed deductible. Permitting this deduction could not frustrate the enforcement of the law.

(*Utica Knitting Company* v. *Shaughnessy,* United States District Court, Northern New York—Sept. 15, 1951; *Pacific Mills,* 17 T.C., No. 80; Oct. 26, 1951.)

Taxable Years

Corporate taxpayer's taxable year begins on date of incorporation, and not when actual business activities commenced.

(*Ajax Engineering Corporation,* 17 T.C., No. 12; July 27, 1951.)

The family partnership issue may have an important bearing on the question of taxable years. The admission of a new partner (if recognized) creates a new partnership which may elect a taxable year different from that of its predecessor. On the other hand, where the new member is not recognized as a bona fide partner, the change in taxable year will be disregarded.

(*Walter F. Lucas et al* v. *Arnold and Dunlap,* U. S. District Court, Texas; March 14, 1951; *Elwyn White Tomlinson,* Tax Court Memo Decision—Aug. 31, 1951; appealed.)

Bad Debts

What is the nature of the bad debt loss which arises from a loan by a stockholder-officer to a controlled corporation? Is it a non-business bad debt deductible only as a short-term capital loss, or is it a business bad debt and hence fully deductible? The courts have passed upon this issue *thirteen* times during 1951 and only on *four* occasions have they determined the loss to be a business bad debt.

A study of these four favorable decisions indicates the following:

(a) An individual may engage in more than one business at a time.

(b) A business bad debt need not be in connection only with the business to which the taxpayer devotes the major portion of his time.

(c) Where an individual makes loans to a number of businesses and takes part in their management over and above passively giving financial aid, *he is engaged in the business of investing and personally participating in various ventures.* Resultant bad debts are business bad debts.

(d) If the losses qualify as business bad debts, they may form part of a net operating loss carryback or carryforward.

(e) The promotion, organization and management of a group of real estate corporations constitute a trade or business.

(*R. S. Lander* v. *W. D. Self,* United States District Court, Arkansas; Oct. 23, 1950; *Don R. Hanna,* Tax Court Memo Decision; June 6, 1951; *Weldon D. Smith,* 17 T.C., No 17; July 31, 1951; *Jacob and Charlotte Mark,* Tax Court Memo Decision; Aug. 7, 1951.)

Charitable Contributions

Contribution checks drawn and delivered in 1946 but cashed in 1947 were held deductible in 1946. Taxpayers should not, however, rely on this case as support for improprieties.

(*Estelle Broussard,* 16 T.C. 23; Jan. 9, 1951.)

Embezzlement Losses

When is an embezzlement loss deductible? In the year of occurrence or year of discovery? This troublesome point remained largely unresolved during 1951.

Where an embezzlement occurred over a number of years, the resultant

loss was not deductible in the year of discovery.

(*Martha L. Alison* v. *U. S.*, U. S. District Court, Pennsylvania; May 17, 1951.)

Where, however, the exact dates of the embezzlement could not be ascertained after diligent efforts to do so, the loss was permitted as a deduction in the year of discovery.

(*Stevenson-Chislett Inc.* v. *U. S.*, U. S. District Court, Pennsylvania; June 28, 1951; appealed.)

The unfair results of these decisions did not apparently bother the court. It would appear that where the embezzler is inept or the accountant astute and, as a consequence, the dates of embezzlement can be established, the taxpayer may lose the deduction if the crime is discovered late. But where the embezzlement dates cannot be ascertained, there is a likelihood that the taxpayer may deduct the loss when discovered.

Expenses Paid After Sale or Liquidation

Payment by a stockholder, as transferee after liquidation, of a corporate tax deficiency or other corporate expense, is deductible as an ordinary loss and not as as long-term capital loss.

(*Seth M. Milliken*, 15 T.C. 243; Sept. 21, 1950 (N.A.); *Frederick R. Bauer, et al.*, 15 T.C. 876; Dec. 14, 1950 (N.A.); *Tatem Wofford*, Tax Court Memo Decision; July 31, 1951; *Frederic M. Paist*, Tax Court Memo Decision; Oct. 11, 1951.)

A somewhat related case yielded a different result. Petitioner sold stock subject to an agreement to refund a portion of the sales price if certain eventualities occurred. Pursuant to this agreement, taxpayer was obliged to make a refund in a year subsequent to sale. This payment, the court held, was not deductible as an ordinary loss and distinguished it from the foregoing line of decisions by pointing out that the payment in question was made pursuant to the contract of sale. Hence, it was an adjustment of that sale and deductible only as a capital loss.

(*Duveen Brothers, Inc.*, 17 T.C., No. 15; July 31, 1951.)

Post-Liquidation Sale

Corporate taxpayer was held not to have realized income from the lease and sale of its property by stockholders after liquidation.

(*J. T. Wurtsbaugh* v. *Commissioner*, (CCA-5) March 28, 1951; *Doyle Hosiery Corporation*, 17 T.C., No. 70; Oct. 10, 1951.)

On the other hand where the post-liquidation sale was initiated and negotiated by the corporation, the resultant gain was taxed to the corporation.

(*St. Louis Union Trust Company* v. *Finnegan*, U. S. District Court, Missouri; Dec. 7, 1951.)

Capital Gains

As long as high rates on ordinary income continue to prevail, the search for long-term capital gains will go on unabated. In 1951, the following decisions in this connection should be of interest:

Where a lessee sells or assigns to a new occupant for a valuable consideration his remaining right of occupancy under a lease, any resultant gain would be a capital gain. The courts have, however, gone even further and have ruled that surrendering the premises to the lessor prior to the expiration of the lease was equivalent to a sale thereof, and hence produced a capital gain.

(*Isadore Golonsky*, 16 T.C. 1450; June 29, 1951.)

The dangers implicit in attempting to realize capital gains by partial stock redemptions is illustrated by one 1951 decision which held that a series of corporate distributions had the effect of eliminating entirely the interests of two out of three stockholders and replacing them with two other stockholders. It found that the third stockholder received a similar distribution but at all times remained a one-third shareowner. The retiring stockholders were held to have received liquidating dividends but the remaining stockholder was taxed on his distribution as an ordinary dividend under Section 115(g) I.R.C.

(*James F. Boyle* v. *Commissioner*, (CCA-3) Feb. 27, 1951; cert. den., Oct. 8, 1951.)

Sale of the good will of a business will produce a capital gain.

(*Lester T. Cox et al* v. *U. S.*, U. S. District Court, Arizona; June 18, 1951.)

Taxpayer correctly reported the gain on a sale of stock when the amounts received exceeded cost, where said sale was made for an indeterminate amount. However, he erred in reporting the gain as a long-term capital gain because more than six months elapsed between the dates of acquisition and final payment. Since the actual sale was made less than six months after acquisition the gain was short term in nature.

(*William A. Cluff*, 17 T.C., No. 27; Aug. 20, 1951.)

Taxpayer issued an option to purchase stock which had been held by him less than six months at that date. The option was exercised at a date more than six months after acquisition. It was held that the resultant profit was to be treated as a long-term capital gain.

(*George N. Dorrow, Jr.* v. *E. L. Deal, et al.*, U. S. District Court, Alabama; April 19, 1951.)

Section 102 Surtax

In five encounters with the courts on cases involving the imposition of the Section 102 penalty surtax, the taxpayer emerged victorious three times. The following observations may be gleaned from some of these decisions:

Evidence was submitted proving need for expansion but there was no proof that the taxpayers had formally or informally decided to commit any corporate funds to the construction of such facilities.

The court was not influenced by the fact that material shortages made it impossible to put the contemplated expansion plans into effect.

The court considered the redemption of preferred stock without a legal requirement to do so as an adverse factor.

The failure to pay accumulated dividends upon the redemption of stock was frowned upon by the court.

(*Koma Incorporated* v. *Commissioner; Tulsa Broadcasting Company* v. *Commissioner*, (CCA-10) May 16, 1951.)

On the other hand the taxpayer successfully avoided the Section 102 surtax by submitting proof of the following:

Funds were needed to finance increased inventories and receivables resulting from expected increase in sales volume.

Corporation planned to purchase the property it rented.

(*Shaw & Keeter Motor Co.*, Tax Court Memo Decision; Aug. 16, 1951.)

Taxpayer was engaged in a program of converting its small stores into super-markets.

(*A. H. Phillips, Inc.*, Tax Court Memo Decision; Oct. 22, 1950.)

Time for Accrual

The question of when items of income or deduction accrue for tax purposes continues to plague both taxpayers and the courts.

Taxpayer was engaged in strip mining activities and was obligated to refill the properties as soon as mining operations were concluded. Work in the mines was concluded in 1945. Taxpayer could not back-fill immediately and accordingly set up a provision in that year for the estimated cost thereof. The actual work was performed in 1946. The court ruled that a legal liability existed in 1945 and only the exact amount thereof was not fixed. The deduction was permitted in the earlier year.

In this case the taxpayer voluntarily adjusted the provision to the actual amount expended. It is by no means certain that this adjustment is required.

(*Paul Harrold* v. *Commissioner*, (CCA-4) Dec. 7, 1951.)

One of taxpayer's ships was requisitioned by the government in 1942 but

the resultant award could not be reasonably ascertained in that year since the prime contractor denied liability. It was held that amounts received in 1947 under the Contract Settlement Act of 1944 could not be accrued and reported in 1942 when the contract cancellation occurred. Nor was it reportable in 1944 when the legal basis for the award came into being since it was not then ascertainable. It was taxable in 1947 when fixed and paid.

(*Henry Hess Co.*, 16 T.C., No. 164; June 18, 1951; *The Apex Electrical Manufacturing Company*, 16 T.C. 1171; May 29, 1951.)

Percentage rent based on tenants' sales for years ended January 31 and payable ten days thereafter was held accruable as income for years with respect to which it was due and not for the succeeding year when it was payable.

(*The Heer-Andres Investment Company*, 17 T.C., No. 91; Nov. 19, 1951.)

Petitioner contracted to charge customers an additional amount per unit, in consideration for which it agreed to furnish certain specified advertising services and materials. The court found that these charges were received under a claim of right, without restriction as to disposition, and that no attempt was made to segregate such funds. Accordingly, the unexpended portion thereof was taxable income in the year of receipt, notwithstanding the possibility that refunds of such balances might have to be made in future years.

(*Krim-Ko Corporation*, 16 T.C. 31, Jan. 11, 1951.)

On the other hand, where advances for reasearch purposes were made subject to a strict contractual obligation to make certain studies and to refund the unexpended balance at their conclusion, the court found that a trust fund had been created and that the excess credits were a liability and not income.

(*Broadcast Measurement Bureau, Inc.*, 16 T.C. 988; May 10, 1951, Acq.)

Where a 1944 bonus was subsequently found to have been excessive and was therefore paid back in 1946, the Supreme Court ruled that the repayment was a deduction in 1946 and did not represent an adjustment of 1944 income.

(*U. S.* v. *Ellis R. Lewis*, 71 S. Ct. 522; March 26, 1951.)

Presumably, if the excessive bonus had been repaid in the same taxable year when received, taxpayer would have been taxed only on the net bonus actually retained. However, this does not apply when a properly declared dividend is involved. A corporation declared and paid a dividend because it was informed that it was a personal holding company. Within the same taxable year, it was discovered that this dividend was not required and hence it was refunded by the stockholders. The court ruled that the dividend was received under a claim of right and hence was taxable. Presumably the refund was deemed a capital contribution and hence was not deductible.

(*Ellsworth Appel et al.* v. *U. S.*, U. S. District Court, Missouri; June 20, 1951.)

Methods of Accounting

Taxpayer maintained his books of account on the accrual basis but reported on the cash basis for tax purposes. Commissioner correctly adjusted his 1945 return to reflect the accrual basis but erred in adding to that year's income the opening accounts receivable.

(*Robert G. Frame*, 16 T.C. 600; March 8, 1951; appealed.)

Petitioner operated a hotel which involved, in part, the purchase and sale of merchandise. The court agreed with the Commissioner that inventories were a material income-producing factor and had to be reflected for tax purposes. However, it was ruled that opening as well as closing inventories had to be used in the year of adjustment.

(*Marian and Harriette Schuyler*, Tax Court Memo Decision—May 11, 1951; appealed.)

Similarly, where taxpayer kept his books and reported on the accrual basis

except that credit sales were reported on the cash basis, the Commissioner was deemed correct in adding accounts receivable at the year's end to income, but erred in including the opening accounts receivable as well.

(*George and Camille Cohn*, Tax Court Memo Decision, May 11, 1951; *Joseph S. Caldwell*, Tax Court Memo Decision, June 29, 1951.)

In all of the foregoing, the court ruled that no change in method of accounting was involved, merely a change in the method of reporting income. On the other hand, where a taxpayer, operating a hotel or tavern, maintained his books on the cash basis, the court found that they did not fairly reflect income. The Commissioner was, therefore, acting with propriety in placing his returns on the accrual basis. Furthermore, the Commissioner was *not* obliged to give effect to the opening inventory in the year of change.

(*Daniel Montgomery*, Tax Court Memo Decision; June 14, 1951.)

Petitioner reported its income on the completed-contract basis. Prior to the completion of the contracts, it transferred all of its assets in liquidation to its parent corporation. The Commissioner was sustained in allocating to the dissolved corporation its share of the contract profits on a percentage-of-completion basis at the date of reorganization.

(*Standard Paving Company* v. *Commissioner*, (CCA-10) June 26, 1951; cert. den., Oct. 22, 1951.)

Loan or Stock

The Commissioner continued his efforts to eliminate the tax distinctions between a stock investment and a loan made to a controlled corporation.

Interest on stockholders' loans was disallowed as a dividend distribution where, upon incorporation, the stockholders paid in $75 for stock and $75,000 as loans, a 1,000 to 1 ratio.

(*Kipsborough Realty Corp.*, Tax Court Memo Decision, Sept. 28, 1951.)

Similarly, a stockholder's loss was deemed to be a stock loss rather than a bad debt where a corporation was formed primarily by a transfer of property. The complete stock investment totaled $6,500. The stockholders simultaneously advanced $20,000 on the corporation's unsecured, demand, interest-bearing note. Subsequently, additional funds were advanced for similar notes. The interest on all of these notes was never *fully* paid. The courts ruled that the corporation had been inadequately capitalized and that the loans were, in reality, additional stock investments.

(*Erard and Elizabeth Matthiessen*, 16 T.C. 781; April 13, 1951.)

Advances made by a corporation to its subsidiary without the issuance of notes, without specifying a maturity date and without establishing a right to enforce payment thereof as debts in the event of a default, were deemed placed at the risk of the business and hence investments rather than loans.

(*Powers Photo Engraving Co., Inc.*, 17 T.C., No. 44; Sept. 28, 1951.)

Excess Profits Tax (Old Law)

Proceeds of Use and Occupancy insurance were deemed *not* to constitute abnormal income since they were not attributable to other years.

(*Carroll Furniture Co.*, 15 T.C. 943; Dec. 27, 1950.)

An insolvency reorganization was deemed tax-free even though all of the securities of the resultant corporation were issued only to the first mortgage bondholders of the predecessor. The former stockholders and second mortgage bondholders received none of the securities of the new corporation. Petitioner was held entitled to the predecessor's basis for depreciation and invested capital purposes.

(*Connohio, Inc., et al.*, Tax Court Memo Decision; Dec. 7, 1950.)

Borrowings to finance the purchase of key-man and stock repurchase insur-

ance policies were held to have been incurred for business purposes and hence were properly includible in borrowed capital. The same conclusion was reached where the borrowed funds were invested in bonds as part of a program to build up bank credit and where a profit was realized on the sale of said bonds and on the interest collected.

(*The Emelord Co., Inc.* v. *Commissioner*, (CCA-3) May 10, 1951; *Mahoney Motor Company* v. *Commissioner*, (CCA-8) Nov. 20, 1951.)

Family Partnerships

There were 49 favorable and 24 unfavorable decisions involving family partnerships during 1951 without producing any marked changes in prevailing court or government policy.

Professional Fees

Legal fees in connection with contesting a gift tax deficiency were held not deductible. This decision, which the writer respectfully believes to be unsound, is being reviewed by the Supreme Court.

(*U. S.* v. *Joseph T. Lykes*, (CCA-5) April 27, 1951.)

On the other hand, fees in connection with securing an estate tax refund or resisting an estate tax deficiency were ruled deductible.

(*R. Stewart Malloch* v. *Westover*, U. S. District Court, California; Feb. 16, 1951; *Estate of Frank L. Gray*, Tax Court Memo Decision; Aug. 28, 1951.)

Fees and litigation expenses incurred by a corporation are fully deductible even though stockholders are co-defendants.

(*American Factors, Limited* v. *Kanne*, U. S. District Court, Hawaii; Oct. 23, 1951.)

Counsel fees paid by a trust beneficiary to protect his interest in trust income and corpus were held deductible as a non-business expense.

(*Herman and Gay Fletcher*, Tax Court Memo Decision; Aug. 28, 1951.)

Legal fees incurred in connection with bankruptcy proceedings were held capital expenditures and hence not deductible.

(*International Building Company* v. *U. S.*, U. S. District Court, Missouri; Jan. 22, 1951.)

The time for deducting legal and accounting fees received its fair share of attention during 1951. Where an accountant was retained in 1943 to audit taxpayer's 1942 records, performed his services and was paid in 1943, his fee was deemed deductible in the latter year. Legal services rendered over a period of years did not accrue ratably, but accrued and became deductible only when a basis arose for setting the amount thereof within reasonable limits.

(*Accurate Tool Co., Inc., et al.*, Tax Court Memo Decision; April 11, 1951; *Canton Cotton Mills* v. *U. S.*, U. S. Court of Claims; Jan. 9, 1951.)

Mortgaged Property

The excess of the mortgage over the net cost basis of the property constitutes a taxable gain to the mortgagor upon the surrender of the property to the mortgagee.

(*Philip S. Parker, Jr.* v. *Delaney*, (CCA-1) Dec. 28, 1950; *Woodsam Associates, Inc.*, 16 T.C. 649; March 28, 1951.)

Where a loss is incurred by the mortgagor on foreclosure and the premises is rental property, it is fully deductible under section 117(j), Internal Revenue Code.

(*Herbert and Doris Rothschild* v. *Berliner*, U. S. District Court, California; Oct. 2, 1950.)

The basis of the property acquired by the mortgagee upon foreclosure is its fair market value regardless of how the mortgage was acquired.

(*Achilles H. Kahn*, 16 T.C., No. 117; May 4, 1951.)

Miscellaneous Decisions

Where an individual paid salaries to children which were deemed unreason-

(Continued on page 120)

Practice and Procedure in the Office of the Collector of Internal Revenue

By DAVID ZACK, C.P.A.

THE average practitioner probably has more contact with the Office of the Collector of Internal Revenue than with any other section of the Bureau of Internal Revenue. Notwithstanding this fact, however, there is less information available about practice and procedure in this organization than in any other division of the Treasury Department. An attempt will be made in this paper to present those procedural aspects of the Collector's operations which would have the most practical interest for the accounting and tax practitioner.

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Function of the Collector's Office

The Collector of Internal Revenue, is, as the name implies, the treasurer of the Bureau of Internal Revenue rather than its auditor—which function is served by the Offices of the Internal Revenue Agent in Charge. As such, the Collector is primarily concerned with a taxpayer's ability to pay and the actual physical collection of the tax rather than the mere theoretical and technical legal tax liability. Of course, as in all large organizations, there is some overlapping of functions and the Collector's office is charged with a small amount of auditing duties. The following listing represents the major aspects of the responsibilities of the sixty-four collectors whose offices service the United States of America and its territories:

1. Issues all tax forms and accepts the executed returns.
2. Grants extensions of time for the filing of returns.
3. Imposes and collects penalties for late filing and failure to file.
4. Assists taxpayers in the preparation of their returns.
5. Keeps all the accounts and records.
6. Makes assessments of tax.
7. Collects the assessments.
8. Audits small returns.
9. Has wide jurisdiction in connection with excise and miscellaneous taxes.
10. Canvasses his district in order to discover taxable persons and objects.

Internal Organization

The Collector's office has to cope with a tremendous administrative problem—the classification, analysis and listing of well over seventy-five million

tax returns every year. This invloves a huge staff with its concomitant personnel problems and the maintenance of detailed and intricate records. It might be helpful to the practitioner to have at least a general idea of the nature of this internal clerical operation.

When the returns are initially received at the Collector's office, they are sorted several times in accordance with specific principles of segregation. The returns are classified as to type of tax, specific forms, with or without remittance, nature of remittance, etc., etc., etc. Income tax returns are then classified as Agent or Collector Returns, depending upon the amount of adjusted gross income and gross receipts in the case of individuals and the character of the returns in the case of other taxpayers. Generally speaking, Form 1040s with an adjusted gross income of less than seven thousand dollars remain with the Collector for audit while other individual returns including those with gross receipts in excess of $25,000.00 or involving capital transactions, notwithstanding the amount of adjusted gross income, are deemed Agents' Returns. Partnership returns showing receipts in excess of $100,000.00 and all corporate returns are likewise transferred to the Agent's Office for examination.

After the returns have been broken down into the various categories, they are numbered in blocks of a hundred. These are the block numbers which are so often referred to in connection with the identification of tax payments.

After segregation, classification and numbering, the returns are listed, scheduled or recorded. A return is listed when its face shows a tax liability which is thereupon assessed through the listing mechanism. A Form 23C is generally used for this purpose. If the tax return indicates that a refund is due to the taxpayer, the refund is scheduled for transmittal to the Disbursing Officer of the Treasury Department. This office does not function as a unit of the Bureau of Internal Revenue but is a separate arm of the Treasury Department, which may account for some of the delay in the actual transmittal of refund checks after a refund has been scheduled by the Collector's office. The local Office of the Collector of Internal Revenue has the complete jurisdiction over refunds of less than $1,000.00. Those tax returns which show no deficiency or refund are recorded by the clerical personnel in the Collector's office.

The Audit Section of the Collector's Office reviews all the returns for mathematical accuracy and obvious mistakes on the face of the return. After this preliminary examination, it selects those Collecor's returns which it desires to audit. Finally, all tax liabilities, credits and balances are posted to individual accounts for each taxpayer.

Field Organization

The field division of the Collector's Office is primarily concerned with the actual collection of assessed taxes. This division is generally headed by a Chief Field Deputy who heads a staff of Deputy Collectors. These Deputy Collectors function in squads of twenty-five to thirty men under the guidance of Section or Division Chiefs. The geographical area of the Collection District is usually broken down among the Deputy Collectors who each handle the matters in their respective territories. Some offices have established a Field Clerical Force (FCF) which attempts to clear up some of the delinquent accounts by mail before assignment to a field deputy.

Many field offices have established an Adjustment Section which handles inquiries, complaints and adjustments made by taxpayers in person, by mail and over the telephone. This section acts as a sort of troubleshooter and coordinates the functioning of the other sections in particular situations. Some of the larger offices also have specialized squads of field deputies such as Bankruptcy Squads, Fraud Squads, etc.

Assessment Procedure

The heart of our democratic system of taxation is the so-called "self-assessment" system. In these days of sensation seeking headlines, it is heartening to remember that all but a very small percentage of our vast tax revenue is voluntarily assessed and paid by our law abiding citizens without any coercion whatsoever, other than the simple requirements of the law.

The taxpayer's own return therefore serves as the basis for the original assessment of tax by the local Collector of Internal Revenue. This original assessment may be voluntarily corrected by the taxpayer by means of an amended return. Other assessments will normally result from action taken by the Bureau of Internal Revenue.

If the taxpayer agrees with the proposed findings of a field revenue agent, he will sign a form 870—"Waiver of Restrictions on a Proposed Assessment". This waiver will permit the certification of this tax deficiency on an assessment list to the local Collector of Internal Revenue for assessment and collection. Since the taxpayer has agreed to the assessment of the tax, he is not concerned about the loss of his right to recourse to the Tax Court. However, in the event that the taxpayer should change his mind after the execution of the form 870, it is important that the waiver be retrieved prior to the preparation and certification of the assessment list, otherwise the taxpayer will lose his day in the Tax Court.

Should the taxpayer fail to come to an agreement with the examining agent in the field, a settlement may be negotiated with the conference section in the Office of the Internal Revenue Agent in Charge. This agreement is evidenced by the execution of a similar form 870 and the considerations previously set forth apply with equal force and effect here. A similar procedure results from a settlement in the Technical Staff except that the form used there is an 870 TS which is an ordinary form 870 with the added condition that the taxpayer agrees not to file a claim for refund for the contested tax. The validity of this proviso is not free from doubt and will undoubtedly be discussed in another paper.

If, at any stage of the proceedings in the Office of the Internal Revenue Agent or in the Technical Staff, a statutory notice of deficiency was sent to the taxpayer by registered mail, an assessment will be made against the taxpayer 90 days after the issuance of the statutory notice, unless a petition has been previously filed with the Tax Court.

The Collector of Internal Revenue possesses a very potent weapon for the assessment of tax in the power to make jeopardy assessments. Forunately, this power is used with a great deal of discretion and seldom abused inasmuch as it can do irreparable damage to a business. Whenever the collection of a tax is in jeopardy, the Collector may make a jeopardy assessment without waiting for the expiration of the statutory ninety day period. This power is seldom used in the absence of serious fraud or an attempt to defeat the collection of the revenue by the withdrawal of person or property from the jurisdiction. It is also sometimes used in special situations such as bankruptcies or receivorships where the government must quickly establish its position as a creditor.

Once an assessment has been made against a taxpayer on the books of the Collector, it may be cleared in one of the following four ways:

(1) Payment.
(2) Application or offset of a refund.
(3) Compromise.
(4) Form 53—Collector's Claim for Uncollectible Taxes.

Payment of an assessment may be made voluntarily by the taxpayer or collection may be enforced by the Collector by one of the methods set forth later herein. Any refund of tax due to a taxpayer will be applied against any outstanding deficiencies on the books of the Collector. Refunds due to related

taxpayers generally will not be applied against a deficiency without the express written consent of the party entitled to the refund. Interesting situations have developed in family partnership situations where insolvencies have occurred and family relationships and loyalties have changed. Many such cases will undoubtedly reach the courts for final adjudication.

The procedure regarding offers in compromise will be discussed in detail later herein.

The Form 53 is normally used only as a last resort by the Deputy Collector who cannot secure any other settlement of an assessed tax and is convinced that the claim is uncollectible. This technique is normally used with a great deal of discretion as it could be subject to abuse and is generally reviewed very carefully administratively. It is generally to the advantage of the taxpayer to close an assessment by an offer in compromise rather than by means of a Form 53, inasmuch as the latter is always subject to review and may be reopened at any time prior to the expiration of the statute of limitations.

Collection Procedure

The Collector of Internal Revenue has tremendous power to enable him to collect assessed taxes and penalties and interest thereon. Fortunately, this mailed fist is generally encased in a silk glove but the potential knockout blow is ever present and the vulnerable taxpayer should keep his defenses up at all times. In other words, federal tax liabilities should never be taken lightly —a mere lapse of time is never a substitute for payment or settlement.

The collection machinery is generally set into motion, after the receipt of an assessment, by the issuance of a 10 day notice of assessment and demand for payment. The Form 23c which the Collector receives from Washington as part of the assessment list starts the running of the statute of limitations on the collection of the tax. If the demand for payment is not honored there is a 5% mandatory penalty for failure to pay all taxes, other than income taxes. This particular penalty is not subject to later compromise and if the tax will eventually be paid it would seem wise to honor this notice and save the penalty.

If the first notice fails to bring results, the taxpayer will receive a second and sometimes even a third notice before the issuance of a warrant of distraint (Form 69). This warrant generally has all the rights and powers of a docketed judgment and authorizes the Deputy Collector to collect the tax by levy and execution on the taxpayer's personal property. The Collector is now also authorized to garnish the taxpayer's salary, and unlike the restrictions of local law, the Government may garnish 100% of a taxpayer's wages in order to satisfy an outstanding tax liability. Rather than kill the goose which lays the golden eggs, the Collector is usually willing to make an arrangement with taxpayers whereby a portion of the salary is returned to the taxpayer for living expenses, after garnishment.

In addition to the warrant of distraint the Collector has the right to file liens against the taxpayer's real and personal property. These liens have the full legal force and effect of any other recorded encumbrances and are of course generally not very helpful to a taxpayer's credit standing. Most taxpayers are quite anxious to avoid either the filing of liens or the execution of the distraint warrant and try to make voluntary arrangements for the payment of the tax by installments over an extended period of time.

The local Collector of Internal Revenue has the power to enter into informal agreements extending the time for the settlement of tax obligations. These payments always carry the full interest rate of 6% and normally do not extend beyond a 6 months' period. These arrangements are usually predicated upon a sworn net worth statement submitted by the taxpayer which indicates at least a temporary frozen asset condition.

Although the arrangements generally call for a liquidation of the liability within 6 months, the agreements are very often renewed for additional 6 month periods where the facts warrant such consideration. It should be emphasized that the arrangements referred to herein call for full payment of the entire tax plus interest and the only advantage secured by the taxpayer is the extension of time within which payment may be made.

Offers in Compromise

The offer in compromise is one of the most effective tools with which the practitioner may help his client in the office of the Collector of Internal Revenue. In the event that the taxpayer cannot hope to meet his full tax obligation, despite liberal installment arrangements granted by the Collector, the offer in compromise should be given full consideration by the taxpayer's representative. An offer in compromise may be accepted by the Government on either of two premises:

1. Uncertainty as to collectibility.
2. Doubt as to the validity of the liability for the tax.

The first ground is of course predicated upon the taxpayer's inability to pay and therefore depends upon the specific facts of each particular situation. This aspect of the offer will be developed later herein in connection with the procedural requirements.

The second basis for the offer in compromise, doubt as to the validity of the liability, does not mean that a previously adjudicated tax liability may be reopened. The taxpayer is still restricted to his single day in Court but this provision in the law recognizes the fact that there are many situations where assessments are made without the taxpayer actually having that all-important day in Court. This occurs very often when taxpayers do not reply to preliminary inquiries or facts are not available and 90-day letters are issued in order to protect the Government against the expiration of the statute of limitations. Taxpayers then permit the 90-day period to lapse without filing a petition with the Tax Court and an assessment automatically follows without any actual consideration of the underlying issues. Such situations also arise in connection with jeopardy assessments. Sometimes questions of law and fact are so clouded and ever changing, as in the case of family partnerships, as to make the determination of correct tax liability very difficult. All of these conditions may be considered in connection with the acceptance by the Government of an offer in compromise. Generally speaking, however, it is always best if there is some doubt as to the collectibility of the tax which can be coupled with the uncertainty of the legal liability.

Legal Effect of Offer in Compromise

The acceptance of offer in compromise is a legal contract between the taxpayer and the Treasury Department. As such, it is a binding and final arrangement which is voidable only upon a showing of legal mistake or fraud. A compromise under the statute settles the taxpayer's total liability in a particular situation for taxes, penalty and interest. As a final binding arrangement, a compromise may not be reopened despite the subsequent development of net operating loss carry backs, the application of Section 3801, or any other reasons. These factors must therefore be given full consideration by the taxpayer's representative before closing a compromise agreement.

When an offer in compromise is made by a taxpayer, he agrees to waive all prior payments on account of the obligation to the Government and any refunds to which he may be entitled for years expiring prior to the date of the compromise. The statute of limitations regarding the collection of the tax is suspended while the offer is pending and for one year thereafter. The taxpayer also waives any further right of appeal which he may have to the Tax Court of the United States. If the offer

is made to pay the compromise in installments, a default in the payment of any installment, would, at the option of the Government, accelerate all the installment obligations or void the compromise arrangement.

Procedure re Offer in Compromise

The offer to compromise the tax liability is made by the filing of a Form 656. The form should be prepared in draft form first and discussed with the Technical Representative of the Collector's Office. The Collector's Office is generally very cooperative in helping to see that the form is properly drafted in a technical sense. After the form is prepared, the Collector's Office generally likes to have the original and two copies filed. The amount offered in compromise must actually be deposited together with the Form 656 in the form of cash, certified check or postal money order. These cash offers are deposited by the Collector in a separate escrow account and are returned to the taxpayer if the offer in compromise is not accepted by the Bureau of Internal Revenue. The deposit made by the taxpayer is usually borrowed inasmuch as any other funds would be subject to levy by the Collector in the event that the offer is rejected and the monies are returned to the taxpayer. Form 656 C is used where the taxpayer decides to pay the offer in installments, which may not extend beyond 1½ years.

In addition to the Form 656 and the cash deposit, the taxpayer must file Form 433 with the offer in compromise. Form 433 is a net worth and cost of living statement which is prepared under oath and subject to the penalties for perjury. The Bureau of Internal Revenue is as interested in the taxpayer's potential earning capacity as in his current financial status. Assets are considered at their forced sale value and every aspect of eventual collection possibilities is considered by the Government. The age and physical condition of the taxpayer is of course very important as is the possibility of the collection of insurance proceeds in the immediate future.

The Forms 656, 433 and the deposits are filed with the Deputy Collector for his first endorsement. The Collector must physically receive the offer and usually endorses his recommendation which is only the first step in the process. The Collector's Office is authorized to make final recommendation in offers regarding taxes of $1,000 or less. All other cases are sent to the Office of the Internal Revenue Agent in Charge for verification of the net worth and further recommendations. If the case involves a matter which was previously recommended for criminal prosecution, the Special Agent's Office joins in the verification of net worth and ability to pay.

The Agent's Office may make any number of recommendations ranging from complete acceptance to complete rejection of the offer. From the Office of the Internal Revenue Agent in Charge the offer in compromise and related papers and reports go to the Technical Staff for review and final recommendation to the Division Counsel and ultimate approval by the Commissioner of Internal Revenue and the Secretary of the Treasury or Under Secretary or Assistant Secretary of the Treasury, which is required for the final acceptance of the offer. The Technical Staff is the ultimate factor in all cases involving income, estate, or gift taxes.

The local Collector of Internal Revenue has full authority in the disposition of offers of compromise re penalties for late filing and failure to file tax returns. There is usually no question of ability to pay in connection with these particular offers in compromise and the Collector's Office is usually willing to accept any reasonable business cause together with an offer equal to one-half of one per cent per month of the delinquent tax. In this connection it should be remembered that a tax return should never be delayed because of inability to pay since the return may be filed with-

out any remittance and thereby avoid the imposition of penalties for late filing.

Interest

The question of interest on assessments and refunds has important practical significance which is frequently overlooked by many practitioners. The interest charge on deficiencies is mandatory in the statute and the interest permitted on refunds is purely a matter of legislative grace. The fact that there is no necessary equitable correlation between the two was emphasized by recent legislative proposals that the interest rate on income tax over-payments be reduced to 2% while the 6% charge was maintained on the deficiencies. Fortunately, this inequitable approach was not adopted by the Congress but it illustrates the fact that the taxpayer has no basic rights regarding the payment of interest on over-assessments.

Interest charges are made for the use of money notwithstanding any question as to the ultimate validity of the underlying tax assessment. Normally the Treasury Department will make no demands for tax payments prior to actual assessment but since the tax may have accrued on a prior date, interest will nonetheless be chargeable. Such interest charges may be avoided by the taxpayer by the payment of funds before any assessment. These moneys are deposited by the Collector into a suspense account until such time as they may be credited against a specific assessment. However, in the event that such payment exceeds the ultimate assessment, no interest will be paid on the overpayment. Payments made with tentative returns when extensions are received for the filing of a return fall into this category.

The interest rate is normally 6% on deficiencies and refunds. However, this is not a blanket rule and is subject to specific exceptions. Thus, the tax deferred by the application of a tentative carry-back loss (Form 1045 for individuals and 1139 for corporations) bears interest at the rate of only 3%. Where the taxpayer receives an extension of time for the payment of estate tax because of undue hardship, there is no interest charge for the first 3 months and the rate is 4% for the remainder of the period. The interest rate on judgments is also 4%.

In connection with computation of interest on deficiencies the computation is made from the original due date of the tax return. The taxpayer therefore loses, for the purposes of the interest computation, any advantage of installment payments which may be permitted by the statute. On refunds, on the other hand, interest is computed from the actual date of the payment and where payments are made in installments it is presumed that the tax refunded was the last installment paid so that the interest credit is reduced to a minimum. These computations should be checked carefully as the local Collectors are often behind on their posting and mistakes can easily be made.

Interest resulting from the carry-back of a net operating loss commences from the date of the filing of a claim for refund. Form 1139, the so-called "quickie" claim is not a claim for refund and no interest is allowed when payment is made within 90 days. In the event that the taxpayer does not receive his refund within the 90-day period, a regular refund claim should be filed on Form 843 in order to protect the taxpayer's claim for interest. In the event that the net operating loss carry-back results in the increase of another tax, interest commences to run on all the taxes simultaneously from the date of the filing of the claim for refund.

The United States Supreme Court in the famous *Seeley Tube and Box Co.* case, 333 U. S. 561, decided that the carry-back of the net operating loss which more than offset a deficiency for the earlier year does not eliminate the interest charge on the deficiency from the due date of the return to the date of the application of the refund. We

therefore have the anomalous situation where a taxpayer is charged with interest on a tax for which he is not liable. That doctrine seems to have been weakened somewhat by the *Babcock-Wilcox* case in the Southern District of New York on July 5, 1951, when the District Court decided that the taxpayer was not liable for interest on additional income taxes which were offset by an overpayment of excess profit taxes arising out of the same transaction, namely the application of the 80% over-all limitation. The Court held that there was merely a reallocation of the total taxes which remained unchanged and that there was no deficiency in income tax and overpayment in excess profits taxes. It will be remembered that under the World War II law the excess profits tax was completely separate from the corporate income tax so that it would seem that the Court was motivated by equitable considerations. It would seem that similar considerations applied in the United States Court of Claims in the case of *Henry River Mills Co.* v. *U. S.*, April 3, 1951, when the Court refused to permit an interest charge against an excess profit income tax deficiency which was wiped out by the allowance of a Section 722 Relief Claim. In that case the Court seized upon the technicality that no excess profits tax deficiency had ever been determined or assessed and therefore vitiated the interest charge.

Interest charges are computed to the earlier of the date of assessment or payment. If a deficiency is not paid within 10 days of the notice and demand, interest accrues on the assessed interest and may be re-assessed. The Field Deputy Collector personally computes the interest charges on assessments for which warrants of distraint have been issued. In the event that the taxpayer has signed Form 870, interest ceases to run 30 days after the acceptance of the waiver or on the date of actual assessment of the tax, whichever is earlier. Interest on refunds is computed to within 30 days of the date on which the check is issued. Where an over-assessment is applied as an offset to a deficiency, interest on the refund is computed to the date of offset.

Interest is computed on the basis of years, months and days. On the basis of the 6% rate, computation is made at 6% per annum and ½% per month and .00016438356 per day.

This paper does not pretend to be an exhaustive study of the subject inasmuch as such a work could well fill volumes. It is merely hoped that some of the material touched upon herein will serve in some small way to alleviate the heavy burden carried by the accounting practitioner.

Procedure Before the Internal Revenue Agent-In-Charge

By Richard S. Helstein, C.P.A.

To every accountant, sooner or later, there comes the first income tax examination. This "first" is something like making a speech—you know what you have to say; but you don't know how it will be received. On the other hand, there are those to whom examinations are a regular daily routine. To them some of the following may seem axiomatic and standard procedure. Having been on both sides of the fence, however, we feel that there are suggestions from which even the most experienced can profit.

An income tax examination is actually nothing more or less than a business conference, the outcome of which is partially dependent upon the goodwill and respect of the participants for each other. A representative who is liked and respected by Bureau Agents can have a most successful tax practice.

It must be borne in mind that the members of the Bureau of Internal Revenue are generally extremely capable men. Many of them are attorneys or certified public accountants. Furthermore, every one of them has taken the Bureau course in Federal Income and Excess Profits Taxes, which is an excellent one.

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This paper was presented by him at a technical meeting of the Society held on October 4, 1951, under the auspices of the Committee on Federal Taxation. Mr. Helstein has also written for the "Journal of Accountancy."

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In one respect, however, an income tax examination differs from a business conference or even a trial before a court of law. In an examination by a Field Agent of the Bureau you have the peculiar anomaly whereby the agent is at the same time the judge, the jury and the prosecuting attorney. When there is a point at issue, he presents the opposing arguments as prosecuting attorney; he makes the decision in the role of the jury; and, as the judge, he passes sentence. However, as in all such courts, you have certain rights of appeal.

Preparation for Examination

When you make an appointment with an agent, do not choose a day when you have other important appointments. Sufficient time should be allowed to do justice to your client, and not to rush the agent. Agents too, have production schedules and the way their schedules are geared, they cannot afford to change the program which they have laid out for themselves, and spread a one day examination over several days because of your obligations. It is also important both for you and for them that you arrange before the examination that they have privacy and comfortable working conditions.

The most essential requirement, however, is that you be prepared for the examination. Remember that under the law, the taxpayer bears the burden of substantiating deductions, and without that substantiation, even the "Cohan Doctrine" bears heavily against the taxpayer. In connection with being prepared, it is advisable to

compile in advance certain analyses and reconciliations which will unquestionably be required by the examining officer. Being unprepared, and fumbling for explanations gives rise to suspicion or impatience on the part of the agent—a situation to be avoided at any cost. Conversely, the submission of the prepared analyses, reconciliations and arguments suggested below can avoid waste of time during the examination and create a favorable impression upon the examining officer.

Have a reconciliation ready if the figures as set forth on the return are prepared on a different basis from those reflected on the books or the financial reports. (The most common are: depreciation, bad debt reserves, or pension trust payments, the tax bases of which often differ from the accounting bases.)

Prepare explanatory schedules for any expenses which are reclassified for tax return purposes. (Depreciation, included in "Cost of Goods Sold" in the accounting statement, will be included as a separate item on the return. It will therefore be necessary to reconcile "Cost of Goods Sold" between the statement and the return.) If certain expenses are combined on the return, have explanatory schedules available. Have explanation and analyses of reserves, and capital and surplus adjustments.

In the case of expense deductions, which are always open to question, such as "Travel and Entertainment", collect your substantiating evidence beforehand.

Be prepared to justify items on which there may be a question of law, as under Section 112. Where there is a question of law, do not hesitate to call in or work with a qualified attorney.

In many cases, you will be asked to secure a Waiver extending the Statute of Limitations (Form 872) when the Agent feels that your case cannot be completed before the effective date of the Statute of Limitations. Unless there is a very definite reason for non-compliance, the waiver should be executed. If it is not, the agent will have to rush through his examination and report, resolving all questionable items against the taxpayer.

Examination

In an examination, where the items in issue are ordinary "run of the mill" ones, it is best to settle the case at the Agent's level. It is just as much a triumph, and just as effective to talk the corner traffic cop out of a ticket as to convince the police lieutenant or the judge—and a lot less time consuming. Holding out on principle alone, if you win, may prove to be a pyrrhic victory.

Occasionally there may be an issue where you believe the Agent is entirely in the wrong or that the Bureau ruling is fallible. Weigh it in the light of the fact that making tax law is a costly process and may extend over several years. Besides, if you lose—the interest keeps running.

It is well to remember that if no agreement is signed, any compromise settlements offered by the Agent will be withdrawn and the items in question totally disallowed. Such a disallowance, if upheld, can set a precedent for disallowance of similar items upon future examinations of subsequent years' returns. Conversely, a compromise settlement of one item may avoid the disallowance of another which would set such a precedent for future years.

Before commencing an examination, and if necessary during the course of the examination, it is well to discuss and determine with your client the range of settlement with which he will agree, so that you will not be subsequently embarrassed if you close the case with the agent and the taxpayer objects to signing the agreement form.

If an agreement is reached, and there is a deficiency, you will be requested to have your client execute a Waiver on Form 870. If there is an overassessment, the form used will be #873. If there are involved both deficiency and

overassessment in different taxes or tax years, Form 874 will be executed.

These forms are not "closing agreements". They are waivers, under Section 272 (d) of the Internal Revenue Code, of the taxpayer's rights as set forth in Section 272 (a). Section 272 (a) provides that the Commissioner must mail a statutory notice of deficiency under which the taxpayer has ninety days to file a petition before the Tax Court of the United States, and that no such deficiency can be assessed nor any action taken to collect same until after the expiration of the ninety days or the promulgation of the Court's decision.

Therefore, if the "waiver" is signed, the taxpayer loses his right to petition the Tax Court for review of the findings. On the other hand, interest stops accruing thirty days after the signing of the "waiver."

That, actually is all that the Form 870 represents. The findings of the examining officer, which have been accepted are subject to review and post-review, either one of which may reverse the determination of the examining officer, and cause abrogation of the agreement.

On the other hand, the taxpayer has the right, at any time before the effective date of the Statute of Limitations, to file a Claim for Refund (Form 843) which, if denied, may be taken to the District Court. It is not advisable to sign a form 870 with this intention in mind, unless it is discussed with the Agent and he is apprised of such intention.

If, during the examination, there is disagreement on interpretation of law, or the allowance of some deduction, and an impasse is reached, it is possible to request an informal conference with the Agent's group chief. This is a process which is too little used and which often offers a solution that results in an agreed case.

In cases where no agreement can be reached, the taxpayer has the choice of three methods of appeal. The election to be made is dependent upon the tribunal before which it is most desirable that the issue be tried.

The step usually taken is to have the case sent to Conference. In many cases where the Agent's hands are tied, or he is unwilling to take the responsibility for making a decision on an interpretation of law, the Conferee, at a higher level, generally has more discretionary authority and more confidence in his own judgment because of prior experience with similar issues.

A second alternative, as discussed before, is to sign the agreement Form 870, and to file a Claim for Refund. In such a procedure, the case is tried either in the District Court or the Court of Claims. The legal advantages or disadvantages of these tribunals will not be discussed herein. Any case referred to such Courts should be handled by a qualified attorney.

A third avenue is to request the issuance of a Statutory Notice (more popularly known as a "90-day letter"). In such event, the case will be tried before the Tax Court of the United States.

Preparation of Protest

If you elect to take your case to Conference, in due course you will receive a copy of the Revenue Agent's Report under a Letter of Transmittal which, in most cases, allows you thirty days in which to file a Protest to the Agent's findings. The period of time which is allowed to file the Protest is discretionary with the Bureau; there is no statutory provision for this. In some rare cases, where the Statute of Limitations is near expiration, a shorter period may be allowed. In the ordinary case, it is possible and usual for the Bureau to grant extensions of thirty days in which to file the Protest if sufficient reason is given for non-compliance with the original period. Since the Protest can be a most important factor in the Conferee's determination of the issues in question, it should be carefully prepared.

Accompanying the "thirty-day let-

ter", you will receive a mimeographed or printed form setting forth certain information which *must* be submitted and the format in which it should be presented. It is advisable to follow this form, since it is prepared in such a way that it will convey vital and basic information in the most efficient manner.

After setting forth this routine information, the taxpayer then presents its grounds and arguments in respect to the items protested. There should be discussed, in the Protest, only those disallowances with which the taxpayer disagrees, and they should be set forth under the definitions, and as they appear, in the Revenue Agent's Report.

Under each heading set forth in the following order (1) the facts, (2) the Revenue Agent's determination and his reasons therefor and (3) your discussion and arguments.

It is always advisable to cite cases, the decisions in which were favorable to the taxpayer's position. It is of equal importance to cite, to discuss and to differentiate adverse decisions. Those Tax Court decisions which are most effective are those in which the Commissioner has acquiesced (claims under Section 721 and Section 722 do not need the Commissioner's acquiescence to Tax Court decisions).

It cannot be emphasized too strongly that it is of the utmost necessity to follow through any cases cited by means of a citator service to see if such decisions have been reversed, modified or affirmed upon appeal. To cite a Tax Court decision which supports your point, but which subsequently has been reversed by the Circuit Court of Appeals is far more damaging than not to cite at all.

The importance of citing cases in the Protest should not be underestimated. No advantage will be gained if they are sprung as a surprise at the formal Conference. The Conferee, if he is not familiar with the decision, will only ask for an adjournment so that he can study it. However, if such decision has been presented in the Protest, and the Conferee has had time to review it in advance, he may be favorably disposed toward the argument.

If in his report, the Revenue Agent relies upon cases or Bureau Rulings, it is important to show wherein such authorities do not apply to the instant case, or to differentiate the facts in the referred-to rulings and cases from those in the point at issue. It is also advisable to Shepherdize the Agent's citations.

In closing the Protest, an oral hearing should be requested.

Conference

Although the oral hearing is known as a "Formal Conference", the actual discussion is informal in character. However, at each Formal Conference you are required to present (1) your Treasury Card, (2) Powers of Attorney in triplicate, (3) Statement in Respect to Fees and (4) if you were employed by the Bureau within the two years preceding the Conference, a Form 901, which is an affidavit by you that you had no association with the case in question during your employment by the Bureau.

A Conference is similar to a Field Examination except that the case is narrowed to the protested items. Another difference is that the Conferee has already familiarized himself with the issues through the file, the Revenue Agent's Report and the Protest, and has researched all applicable decisions and rulings.

If, in regard to the items in issue, there is any question of fact still involved, and it is necessary to present proof at the Conference, prepare sufficient photostatic copies of the documents of proof so that copies may be submitted to the Conferee for his files. Affidavits should be phrased to cover the issue adequately. Affidavits by disinterested parties are most desirable; an affidavit by the taxpayer may be considered as "self-serving" which detracts from its weight.

The Bureau has a system, after a case reaches the Conference level, whereby, if there is a case involving a similar issue docketed before the Tax Court, your case may be held in suspense until decision is promulgated on the docketed case. This procedure may be advantageous if you are sure that the issues are the same, and that the facts are the same as in the docketed case, since the Bureau will not rule favorably upon your case while it is trying the same issues in the courts, and you can therefore be saved the expense of further processing your case. The disadvantages are twofold: the interest continues to accrue, and your case, in the Bureau's files, is irrevocably associated with the case the decision on which is awaited. As a result, if there is an adverse decision in the ruling case, it is certain that the decision in your case will be adverse throughout the Bureau.

One of the most difficult questions confronting a practitioner is whether to take his client to the Conference. This cannot be answered in either a flat negative or positive; it depends both upon the individual case and the individual client. It is a natural reaction for the accountant to wish the client to see the difficulties involved, the obstacles to be overcome, and to appreciate any triumph that may be achieved. However it must be borne in mind that if the discussion is to be a technical one involving the complications and involutions of the Internal Revenue Code, the client will be out of his depth. If the discussion is one which involves compromise, and general give and take, the client's natural, personal interest and bias may hamper negotiations. Obviously the client is concerned with the practical problems of his business; on the other hand, the Conferee is interested in the application of the law. Further, your client may object to certain concessions which you may consider advantageous in order to avoid setting a precedent through disallowance of other issues. All of these must be weighed carefully in reaching your decision.

If agreement and settlement is attained in the conference status, the forms to be executed are the same as those already discussed. If no agreement is obtained, the taxpayer has open to it any one of three avenues of appeal: it may sign Form 870 and file a Claim for Refund; it may request the issuance of a Statutory Notice; or it may request that the case be referred to the Technical Staff.

Procedure before the Technical Staff and in Connection with Special Bureau Rulings

By OSCAR HANIGSBERG, C.P.A.

Technical Staff

IF a taxpayer does not agree with the disposition of his case by the Internal Revenue Agent's Office, he may avail himself of several options. He may pay the tax, then file a claim for refund; or, he may invite the issuance of a statutory notice, then petition the Tax Court; or, he may ask for a hearing before the Technical Staff. The first alternative will usually bring the taxpayer to a District Court, assuming the Internal Revenue Bureau's action on the claim is adverse; the second alternative will bring the taxpayer to Tax Court unless the case is settled before trial; the third alternative presents a further opportunity for an informal hearing within the Bureau at the conclusion of which it is still possible to choose one of the first two alternatives. The practitioner who handles a case at this level should be alert to the possibility that the services of an attorney may be necessary to evaluate the case from the viewpoint of litigation, and to decide the best procedure to be followed.

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This paper was presented at a technical meeting of the Society held under the auspices of the Committee on Federal Taxation, on October 16, 1951, at the Engineering Auditorium in New York City.

Technical Staff Settlements

The Technical Staff is the highest appellate agency within the Bureau of Internal Revene in matters involving income, profits, estate and gift tax liabilities. It is separate from the Internal Revenue Agent's Office, not being a part of the Income Tax Unit. The head of each field division of the Technical Staff has full authority to act for the Commissioner of Internal Revenue; therefore, any action taken by a field division is final and not subject to any post-review by Washington.

The Technical Staff, like all divisions of the Bureau of Internal Revenue, must be guided in its actions by Bureau rulings and policies. The Technical Staff does, however, take into account the litigating strengths or weaknesses of the opposing views of the taxpayer and the government and its settlements may take the form of trading one doubtful issue for another or they may take the form of settling the proposed deficiency for a lesser amount. In these respects, they differ from settlements usually made in the Internal Revenue Agent's Office which hold for or against the taxpayer on each issue based on the application of law or Bureau policy to the findings of fact.

An offer to settle a case is customarily initiated by the taxpayer's representative. The Technical Staff does not accept settlement proposals which are based upon nuisance value of the case to either party. Therefore 10 percent or 80 percent settlements are rarely recommended. The reason for this is that if the taxpayer is willing to give up and the Government to accept not over 20 percent, or if the Government is willing to yield not over 80% from

full payment, it is highly probable that the answer is not subject to substantial doubt and it is considered that the taxpayer should pay either nothing or 100 percent.

Where there is only one important issue in a case, the Technical Staff is loath to compromise the issue if to do so would leave open the same or a related question in connection with other taxpayers or taxes for other years. Such cases are usually not compromised in the pre-statutory stage, and in the post-statutory notice state (see below) are compromised only if the Government's case presents an exceedingly doubtful outlook, and then only if an offer advantageous to the Government is made. In cases where compromises are made, the Technical Staff obtains letters of commitment as to the method of handling the issue in other years.

Technical Staff settlements are evidenced by Form 870-TS which is similar to Form 870 used by the Internal Revenue Agent's Office, but which differs from it in two respects. First, it is phrased as an offer to waive the restrictions on the assessment of tax rather than as a waiver of the restrictions. Practically this means that interest on the deficiency ceases to run thirty days after it has been accepted for the Commissioner rather than thirty days after it has been submitted by the taxpayer. Second, Form 870-TS includes additional phraseology to the effect that the taxpayer agrees that he will not seek refund of any tax covered by the agreement and deletes the phrase appearing in Form 870 to the effect that a further deficiency may be asserted. The purpose of these changes is to utilize Form 870-TS as a substitute for a formal closing agreement under Section 3760 of the Internal Revenue Code. The effectiveness of Form 870-TS for this purpose has been challenged with differing results. There is presently an open conflict in the courts as to the effect of such waivers in precluding refund actions by taxpayers.

Factors Affecting Decision to Appeal to Technical Staff

There is expressed among tax practitioners much difference of opinion as to the wisdom of appealing cases within the Bureau. The following disadvantages are often stated:

(a) Bureau appeals involve the expenditure of much time in proceedings which are essentially repetitious because all Bureau personnel are bound by the same rulings.

(b) While Bureau appeals are pending, interest on the possible tax deficiency continues to mount.

(c) In the course of appeals the Bureau will learn all the weaknesses of the taxpayer's case.

(d) During the course of the appeals the Bureau may raise completely new issues.

(e) The Bureau will never accept a fair settlement until it is convinced that the taxpayer is determined to test the matter in the courts.

Each of these objections contains some element of validity which the practitioner should not overlook, but it would be incorrect to conclude therefrom that Bureau appeals have only disadvantages.

(a) If a matter of law is in dispute on which the Bureau has taken an adverse stand, it is of course true that a favorable result will probably not be achieved within the Bureau. In such a case Bureau appeal may well be fruitless and the taxpayer's case unnecessarily exposed. It is not true, however, that the result of a Technical Staff hearing is a mere repetition of conference in the Internal Revenue Agent's Office. The wider latitude and differing basis for Technical Staff settlements has been indicated above.

(b) Interest does accrue while a case is being appealed. A procedure exists, however, by which a taxpayer may deposit with the Collector, a sum of money to apply against the

deficiency which may eventuate. This money is credited by the Collector to a "Suspense Account" and the effect is to suspend the running of interest on that amount of deficiency. On the other hand, if the amount is found to be an overpayment, it will be refunded with interest from the date of payment.

(c) There may be some merit to the argument that appealing a case in the Bureau will expose all of its weaknesses to the Bureau in circumstances where the factor of surprise may be important. For instance, reserving certain evidence until it is produced in court may upset the position the Bureau took in its statutory notice and make it more difficult for it to assert a new position. Barring such circumstances, to avoid Bureau appeals for fear of exposing weaknesses, is to hope that the courts will be less expert than the Bureau in detecting the weaknesses.

(d) The danger that completely new issues may be raised during the course of Bureau appeals is a real one. This factor must definitely be considered in determining whether to settle, appeal or adopt some alternative procedure.

(e) At all stages, the best settlements are usually obtained by the representative who conveys the impression that he feels strongly about his case and that he will pursue it as far as necessary to secure a fair settlement. To convey this impression, it is not necessary to leap to the threshold of the court. Bureau personnel, on the other hand, are generally willing to make fair settlements where the bases for such settlements are properly developed.

Technical Staff Hearing after Issuance of Statutory Notice

Where a statutory notice has been issued, either before or after a hearing in the Technical Staff, and a petition has been filed in the Tax Court, the case comes under the joint jurisdiction of the Technical Staff and the Chief Counsel's Office. A hearing may again be granted at this stage of the proceedings and it is sometimes possible to achieve a satisfactory settlement where none was possible previously because the opinion of the division counsel representing the Chief Counsel's Office may not be as optimistic about the Government's case as that of the Technical Staff advisor.

A settlement negotiated in this post-statutory notice or docketed stage takes the form of a stipulation which is submitted to the Tax Court which renders a decision as provided in the stipulation. The settlement, therefore, has the full force and effect of a Tax Court decision.

Special Bureau Rulings

Sometimes a taxpayer has engaged in, or wishes to engage in, a transaction the tax consequences of which may be uncertain. In appropriate types of situations it is possible to secure rulings from or to make agreements with the Bureau which will resolve the uncertainty.

Policy on Issuing Rulings

The Bureau in Washington will generally issue rulings on transactions which have been consummated affecting a return to be filed or on proposed transactions. If a taxpayer should request a ruling on a question involving a return already filed, the Bureau would not issue a ruling on the matter but would refer it to the Internal Revenue Agent in Charge having jurisdiction over the taxpayer's return. The Bureau will also not issue a ruling on either a proposed or consummated transaction unless the names of all the real parties interested are stated. Other situations where the Bureau will not issue rulings are where the matter involved is presently a subject of litigation between the Bureau and taxpayers generally or where the taxpayer's motive in engaging in the transaction appears to the Bureau to be primarily tax avoidance.

Effect of Bureau Rulings

A ruling is not equivalent to a formal closing agreement under Section 3760 of the Internal Revenue Code in that theoretically it is not binding on the Commissioner or on the Internal Revenue Agent who ultimately examines the return. It is the policy of the Bureau, however, to consider itself bound by the ruling unless, on examination, it appears that the actual facts differ substantially from those described to the Bureau, or where the statute has been changed subsequent to the ruling. Even formal closing agreements are subject to this same limitation, so that for most practical purposes, a ruling is as effective as a closing agreement.

Procedure for Securing a Ruling

Requests for rulings are made in writing addressed to the Commissioner of Internal Revenue in Washington. The request should include a statement of facts in which are submitted the actual names of parties, dates and figures, together with copies of contracts and other pertinent documents. There should also be included a discussion of code, regulations and cases pertinent to the issue and the reasons why it is considered that the Bureau should rule in the manner desired. The request should conclude with an explicit statement of the question on which the ruling is requested and the nature of the ruling requested. Where it is signed by a representative, there should be enclosed a power of attorney and, if it is desired that the representative receive a copy of the ruling, this should be specifically requested.

It is a good practice before submitting a request in writing, to arrange for a preliminary, informal conference with one of the Bureau people. This practice is helpful for a number of reasons. In the first place, preliminary discussion may indicate that Bureau action will probably be unfavorable. In such a case, it may be decided to drop the whole idea. Preliminary discussion may also suggest amplifying the facts in some manner before the request is finally filed. Where a proposed transaction may be carried out in more than one way, preliminary discussion may indicate that the chances for favorable action are better where one method rather than another is employed. An informal conference may be arranged by simply telephoning to the Bureau and requesting it.

Before submitting a request for a ruling, the taxpayer's representative should satisfy himself that action on the request will not expose the taxpayer to a potential deficiency from some unlooked-for quarter. For instance, a request covering a proposed reorganization of a corporation necessarily involves examination of its surplus which may lead to a Section 102 issue or to the contention that a prior stock dividend, considered nontaxable by the taxpayer, was actually taxable.

Withdrawing a Request for a Ruling

Requests for rulings are acted on quite promptly, and it is not unusual to receive a ruling within ten days from the date the request was submitted. Where more than two or three weeks have elapsed, it is well to check on the progress of the matter. It may be learned that some opposition to a favorable ruling has been encountered and, under such circumstances, it may be desired to withdraw the request.

Most rulings are handled by the Taxpayer's Rulings Section and, if the request is in that section, its withdrawal results in the matter being transferred to the closed file with no further repercussions. Requests for rulings on matters involving corporate reorganization and distribution are handled by a different section called the Securities Unit (of Audit Review Division B). Where such a request is withdrawn the Securities Unit often notifies the Internal Revenue Agent in Charge of the request and of its opinion at the time of the withdrawal. Careful thought should

therefore be given before a written request is made on such a matter.

Closing Agreements

Section 3760 of the Internal Revenue Code authorizes the Commissioner with the approval of the Secretary of the Treasury to enter into closing agreements with a taxpayer respecting his tax liability. Such an agreement may not be annulled, modified, set aside or disregarded unless there has been found a misrepresentation of a material fact or unless, with respect to a taxable period ending subsequent to the date of the agreement, there has been a change in the applicable law.

Closing agreements may be of two kinds:

(a) Agreements as to Final Determination of Tax Liability—Form 866.

(b) Agreements as to Specific Matters Affecting Tax Liability—Form 906.

The first type of agreement is used in closing the total tax liability for any taxable period ending prior to the date of the agreement. The second type is used to cover specific items affecting tax liability and may apply to taxable periods ending either prior or subsequent to the date of the agreement.

The Bureau enters into closing agreements where there may be mutual advantages to the government and to the taxpayer such as in a tax settlement involving mutual concessions or where payment of tax, barred from collection by the statute of limitations, is proposed by the taxpayer. Closing agreements are also entered into in matters coming under Section 506 of the Internal Revenue Code relating to the deficiency dividends on personal holding companies and Section 3801 of the Code relating to the mitigation of the effect of the statute of limitations. Even where there is no particular advantage to the government, the Bureau will enter into closing agreements where the taxpayer has sound reasons for requesting one. Examples are where fiduciaries desire final closings in order to be discharged by the court or where taxpayers desire to follow the consistent practice of closing their returns from year to year.

It is obvious that closing agreements involve considerably more review than simple requests for rulings. It is well to decide which type of action is required before a request is submitted to avoid duplication of effort and, unless there is some compelling reason for requiring a closing agreement, or the matter affects a return already filed, a ruling may be found to be just as effective and much less troublesome to obtain.

Audits—Planning and Review

By WELDON POWELL, C.P.A.

This paper considers the two opposite ends of the audit engagement: planning it in terms of personnel, starting time, evaluation of internal control and audit program; and reviewing it from the viewpoints of the resulting working papers and the responsiveness of the audit report to the requirements of the engagement.

THE various phases of auditing are interrelated and interdependent, and they overlap each other. Because of this, consideration of any one phase generally, such as planning or review, is bound to involve all the others to some extent. In this article I intend to confine myself to certain aspects of the planning and review of an audit engagement—some of the matters which it seems to me a principal should have in mind in connection with these important phases of the work—without attempting an all-inclusive presentation.

Auditing Standards

The Committee on Auditing Procedure of the American Institute of Accountants in 1947 issued a tentative statement of auditing standards. The statement contained a summary setting forth nine standards and a discussion of their generally accepted significance and scope. The members present at the annual meeting of the Institute in the following year approved and adopted the summary in the committee's statement, and resolved that the use of the expression "generally accepted auditing standards" in the reports or certificates of independent auditors should be deemed to refer to the standards or principles set forth in that summary.

First, there are three general standards, which relate to the personal qualifications of the auditor and the general quality of his work and apply to everything he does in his professional capacity:

1. Training and proficiency of the auditor.
2. Independence in his mental attitude and approach.
3. Due care in the performance of his work.

Next, there are three standards of field work:

1. Adequacy of preparatory planning of the field work.
2. Proper evaluation of the examinee's existing internal control for reliance thereon by the auditor.
3. Competence of evidential matter.

Finally, there are three standards of reporting:

1. Adherence to generally accepted accounting principles.
2. Observance of consistency in their application, except where conditions warrant otherwise.
3. Adequacy of informative disclosures whether in the financial statements or in the auditor's report or "certificate."

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You will note that the first two of the standards of field work pertain directly to the planning phase of an audit. As stated in the summary of the committee's statement the first of these reads, "The work is to be adequately planned and assistants, if any, are to be properly supervised." The discussion of this standard emphasizes the timeliness of auditing procedures (that is, the proper timing or synchronizing of the various operations) and the orderliness of their application. It stresses the desirability of the auditor's being appointed early in the year so that he may carry out part of his work during the year. The text of the second standard of field work is, "There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted." The discussion of the review of internal control states that this is one of the most important of the steps in the proper planning of an audit and must not be casually undertaken or carelessly performed. It comments upon some of the considerations which the auditor should have in mind in this connection.

The summary in the committee's statement does not make specific mention of review. This phase of an audit is one of the elements comprehended in the third general standard, which says, "Due professional care is to be exercised in the performance of the examination and the preparation of the report." The discussion of this standard makes it clear that the principal responsible for the engagement must not fail to exercise due care in a critical review of the work done and the judgment exercised by those under him.

At this point it should be noted that the standard of due care applies alike to the areas of the field work and the reporting thereon, and is to be considered, therefore, in connection with both planning and review. The statement of auditing standards points out that due care imposes a weighty responsibility on the auditor to give heed to the procedural standards; that responsibility, within the auditor's organization, rests especially heavily upon the principal heading an examination; that the procedural standards ask of the auditor not merely whether proper procedures have been employed, but beyond that whether, under all the circumstances of a case, those procedures have been properly applied and coordinated; and that the matter of due care having two aspects—since it concerns both what the auditor does and how well he does it—comprises, therefore, considerations not only of auditing procedures but also what may be termed the mechanics of his audit working papers.

Two other elements discussed in the committee's statement should be mentioned here, since they also are pertinent to the field work and the related reporting, and therefore to planning and review. One of these is materiality: items of greater importance should have more attention than items of lesser importance (this does not mean, of course, that details are to be ignored). The other is relative risk: in circumstances where the risk of material errors and irregularities is great, more attention is required than in circumstances where the risk is small.

Assignment of Staff

I am not going to discuss staff management, but I should like to point out that the selection of the accountants to execute the work—the principal, the accountant-in-charge, and the assistants—is one of the elements in planning an examination.

One matter is scheduling the work of the office as a whole. To an individual practitioner with but one or two men on his staff this may not be a problem. Where there is a fairly large staff and there are several principals supervising the work it may require quite a little effort. The first step is the assignment of supervisors. Each engagement, of course, should have the general oversight of a partner. In many engagements

the partner may delegate to a supervisory member of the staff the direct supervision of the field work and review of the working papers and report. In some engagements he may undertake a part or all of this himself. In any case the final responsibility must be his. The next step consists of the matching of staff requirements and available accountants and the development of a schedule of planned assignments, at least once in the fall, for the busy season, and once in the spring, for the summer months and the vacation period. Usually this requires cooperative effort on the part of all of the principals who supervise engagements. In some offices the wholesome practice is followed of informing each staff accountant in advance as to his probable assignments as soon as the office schedule has been completed.

There are two matters I should like to mention in connection with scheduling the work of the office. One is the rotation, at suitable intervals, of the accountants assigned to each client's affairs. The other is the use of field work for the training of staff accountants, not only to make seniors out of green juniors, but also to make principals out of in-charge accountants, and in either case to give each member of the staff a diversified experience. These are sound practices which are followed, to the extent practicable, by a number of firms.

It is, of course, desirable to have a well-trained and thoroughly experienced group on every engagement—accountants who have had both a good accounting education and a thorough training in the technique of the firm, and who have had both wide general auditing experience and some contact with the industry of which the particular client is a part. It is preferable also to have accountants on each assignment who are temperamentally suited to its requirements. The ideal is seldom attained in practice, and this has a bearing on the planning of the audit. With a seasoned staff, the supervisor's part may be more general in character; he may outline the broad course of the work and leave to his subordinates the filling in of the details. With a less mature staff, the supervisor may have to go into many of the details himself, and instruct his subordinates specifically as to what they are to do and how they are to do it; he also may have to arrange to spend a greater proportion of his own time in direct supervision of his assistants during the execution of the engagement, and to review their work more thoroughly at its conclusion.

In any event the supervisor should see that the staff accountants have a clear understanding of the task assigned to them before they start to work. This should cover not only the operations they are expected to perform and the way they are expected to proceed, but also the purpose their work is intended to accomplish. An auditor has to be always on the alert to avoid becoming so deeply involved in detail that he misses the significance of what he is doing. It seems to me to be an important part of the planning to arrange for briefing the staff. Usually this means oral explanation in addition to written instructions. In a large engagement it may take the form of staff meetings held for the purpose of discussing the work.

Staff matters are especially important in a new engagement. Some men have an aptitude for organizing the work in a situation such as exists where an examination of a company's affairs is being made for the first time. Others are at their best only when they are following a well-established pattern. This should be borne in mind in assigning and instructing the staff on an initial examination. Also, the supervisor probably should plan to spend relatively more time on a first audit than on a repeat audit.

Time of Starting Work

One of the things to think about in planning the commencement of an audit is the necessity for effecting surprise. If the examinee is a bank, stock broker, or similar concern, the auditor is at great

pains to take up his examination unannounced. If the examinee is an industrial or mercantile concern there usually is not the same urge to make the initial visit without advance knowledge on the part of the concern's employees, although even here the auditor may, and frequently does, attempt to perform some parts of the work—the counting of petty cash funds, for example—at a time when the employees are not expecting him.

Another matter to bear in mind is the necessity for taking up the work on several different items simultaneously. Cash funds, bank accounts, and securities must be examined as of the same date if the arrangement of duties within the organization is such that substitution or kiting is possible. In some instances this may require consideration with respect to inventories also.

Otherwise, the time of starting the work depends upon the convenience of the accountant and that of his client, availability of staff, dates of physical inventories, and similar considerations. In many engagements, including practically all large ones, preliminary work is done prior to the end of the examinee's fiscal year, and this has to be carefully planned. In a new engagement this would include a considerable part of what might be called background work, which is necessary when the auditor has not previously made an examination of the concern. The desired end is to arrange for as much work during the summer months as may profitably and safely be done at that time, so as to relieve the pressure during the period immediately following December 31. This is a large subject in itself, and I cannot go into it here.

The client's report requirements should be ascertained and kept in mind. The engagement should be taken up in sufficient time, and the work should be divided between preliminary and final in such manner, as to allow for completion of the essential operations and review of the whole by the time the client desires the report. In arranging to meet the client's wishes in this matter, however, the auditor should take care to avoid being unduly rushed at the end. If the time schedule is too close, the pressure is such that the risk of error is materially increased, on the part of both the examinee's employees and the auditors. Investors and others who have occasion to use corporate reports are entitled to receive them within a reasonable time after the close of the accounting period, but even their interests are not served by undue haste in releasing the certified financial statements.

Basic Approach

Frequently — perhaps usually — the plan is to arrange the bulk of the audit work according to the accounts as they appear in the trial balance of the examinee's general ledger and to supplement this by systematic tests of the transactions entered in original records, review of the minutes, and similar operations of a general nature. In a way this is both logical and convenient: inasmuch as the aim of the examination is simply to do the work necessary to enable the accountant to express an opinion upon the examinee's financial statements, and the statements are assembled from the general ledger, the accounts on the trial balance provide a focus for the auditor's work.

In many cases, however, an alternative approach is more effective, which is to plan the audit work so as to gear it to the flow of the accounting work in the concern under examination, which generally parallels the functional organization of the business. Let us consider briefly an industrial concern. Here the accounting work might be organized somewhat along the following lines:

Cash receipts—Receiving, recording, and depositing cash.

Cash disbursements—Preparing, recording, signing, and releasing checks; reconciling general bank accounts; handling petty cash funds.

Sales and trade receivables—Preparing sales orders; shipping and billing; keeping customers' accounts (or notes).

Purchases and trade payables—Preparing

purchase orders; receiving and vouchering; keeping suppliers' accounts.

Payrolls—Preparing employment records; recording attendance and preparing and disbursing payrolls; reconciling payroll bank accounts; handling payroll funds, including employees' deductions.

Costs and inventories—Recording production, costing sales, and establishing the accountability for inventories which should be on hand; having custody of or control over inventories.

Property—Accounting for plant property and equipment.

Securities—Accounting for securities held; accounting for notes payable, funded debt, and capital stock, and special funds for the payment of dividends, interest, etc.

General accounting—Keeping the general books; keeping the details of deferred and accrued items, sundry receivables and payables, etc.; attending to miscellaneous matters.

If the audit work were arranged along these same lines, it would comprehend, as to each of the major departments listed above, investigation of the accounting system and the internal control, tests of the routine transactions, and analysis, inspection, observation, and confirmation of and other inquiry into the pertinent accounts and items. The various steps in the examination would thus be integrated. The review of the internal control would be correlated with the testing and other work on the pertinent records and accounts. The maintenance of an over-all view of each segment of the audit work would be facilitated.

Under such an arrangement there would, of course, have to be some introductory work and some supplemental work of a general nature. The latter would include an analytic review, that is, a study rather than a detail analysis or checking, of the operating and income accounts of the enterprise as a whole.

Also, special attention would have to be given to branch locations, if any. This means inquiry at headquarters as to conditions at the branches, checked possibly by a visit to a nearby location, and outline of the work to be done in view of the nature and relative importance of the branch operations, the extent to which the branches are controlled and audited by headquarters personnel, and similar considerations. If it is not deemed necessary to visit all outside locations every year, there is the question of selection, and probably also that of rotation.

Initial Audit Steps

In the planning and the execution of an audit there is a fuzzy area where the two overlap to a considerable extent. On many occasions a process similar to that of trial and error is followed. A preliminary survey is made, a partial or tentative program of work is laid out, and some operations are undertaken. In the light of the results obtained, the program is completed or revised, and the examination proceeds. This is especially likely to be the case in a new engagement where there is no experience to serve as a guide in considering the examinee's accounting arrangements and evaluating his internal control.

I should like to indicate some of the audit steps to be taken in the initial stages of an engagement, covering points which have a bearing on the future course of the work and therefore are to be considered as elements in the planning. The list below is based on the work program recently prepared for the annual examination of a manufacturing company:

Brief review of the audit working papers for the preceding year and of the carry-forward file, and consideration of any notations therein concerning matters for future attention.

Critical review of the company's financial statements and computation of pertinent ratios for the current period and comparison with at least the immediately preceding period, supplemented by discussion with the comptroller or other appropriate official, for the purpose of arriving at a general understanding of the nature, volume, and trend of the business, the financial condition, and the main accounting problems to be dealt with this year.

Brief general inspection of the principal manufacturing departments, assembly lines, store rooms, etc., and in this connection a first-hand observation of the routine of and control over the paper work in the plant.

Study of the most recent organziation chart,

and consideration of significant changes in the organization during the year.

Review of any changes during the year in the company's accounting manuals and similar written instructions, and in its basic accounting practices.

Review of the work of the internal audit staff during the year, and consideration of its effectiveness.

Arrangement for obtaining access to or copies of minutes, important contracts and agreements, and other pertinent corporate documents.

Consideration of probable report requirements.

Arrangement for obtaining from the company's employees such required detail reports, analyses, and similar papers as may with propriety be prepared or furnished by them.

In the case I am illustrating here, the bulk of the audit work is arranged according to departments of the company's business along the lines indicated above in the remarks on basic approach. Planning of the work in each of these departments, therefore, is required. In each department the first step is investigation of the accounting system and the internal control as fundamental to a decision as to the nature and extent of the testing and other work on the records and accounts. In some of the departments additional exploratory work is called for. The disposition of the company's cash and securities has to be ascertained in advance, in order that proper arrangements may be made for count and confirmation of balances and the necessity for simultaneous examination may be considered. The company's arrangements for sending out statements to customers have to be looked into, so that the work on the detail trial balances and confirmation of individual accounts may be scheduled. A survey of the company's inventory arrangements has to be undertaken, so that a decision may be made as to how much physical testing should be done by the auditors. And so on.

If the company were being examined by the auditor for the first time, the initial work would be much the same as the foregoing, with perhaps some difference in emphasis. In addition consideration would have to be given in this event to review of the corporate history for periods prior to the one being now examined, including perusal of minutes for the prior periods and examination of opening balances in the accounts for property, accumulated depreciation, capital stock, surplus, etc.

I should like to emphasize the importance of planning in connection with the work on inventories. Usually it should be the responsibility of a principal to ascertain the procedures to be followed by the examinee, consider their adequacy, and decide how much physical testing should be done by his crew. A brief memorandum should be maintained in the working papers covering the survey of conditions existing at the plant and conclusions as to control methods. In setting the time to be spent on inventory observation and tests, there should be taken into account the adequacy of the examinee's safeguards over inventories and the relative importance of the amounts involved. In most cases observation need not be extended to include minor parts and supplies and salvage items. In a well-organized concern, all examination purposes may be served by assigning relatively few accountants to observe the work of the employees in taking physical inventories, such accountants to list only items of largest monetary importance, for identification and test to final inventory sheets. Generally, it is more important that the auditor carefully review and satisfy himself as to the adequacy of the examinee's inventory procedures than that he list many items. His approach should be to satisfy himself that the plans for taking inventories are satisfactory, so that a good result will be obtained if the instructions are followed, and then to determine by observation that the instructions are being followed.

Early consideration of matters such as the foregoing should tend to maximize the headwork and minimize the pencil-pushing—a result most earnestly to be desired in any engagement.

Formal Questionnaires and Programs Generally

In a small concern where most of the bookkeeping is done by one person, there being practically no internal control, and where the audit work can be carried out by one accountant in a fairly short time, the use of forms such as internal control questionnaires and work programs would seem to be inappropriate. In such a case the principal may instruct the field accountant orally as to how he is to proceed, and the latter may indicate the scope of his work in the working papers as he performs it; a brief hand-written memorandum may suffice to set forth the essential information as to examinee's records and the lack of effective internal control. On the other hand, in a large engagement where the client's operations are complex and possibly far-flung, and where the services of numerous different accountants are required, some formal questionnaire and program material usually is a necessity.

Between these two extremes are the medium-size engagements, which doubtless constitute the bulk of the average practitioner's audits. As to these there may be a difference of opinion. I shall outline briefly my own preferences.

I do not like rigid standard questionnaires, work programs, or check lists which purport to be all-inclusive and to be suitable for universal use. I think anyone using them runs the risk of doing too much work, or too little work, or the wrong kind of work.

On the other hand, I do favor flexible standard forms which are designed to suggest rather than to prescribe procedures, and to provoke rather than to stifle thought. With these as a foundation, a work program can be developed to suit the peculiar requirements of each engagement. I believe such a work program is highly desirable in most engagements, if for no other reason than that its preparation requires some concentrated thinking about the work in advance. Beyond this, of course, a well-prepared work program serves to keep the course of the field work within due bounds.

Internal Control Questionnaires

I have used the questionnaire approach in evaluating the system of internal control for a good many years.

An internal control questionnaire of the kind I have found satisfactory covers several pages. Each page is devoted to one of the usual major accounting and custodial activities of a business enterprise, and contains space for the names of the pertinent officers and employees, or departments, and questions, together with certain explanatory material, relating to the more important functions within each activity.

The questions are designed to focus attention on particular points at which internal control may be weak, so as to facilitate concentration of testing on the specific records affected and to eliminate unnecessary auditing of records which are adequately controlled. All questions are stated so that an affirmative answer indicates a satisfactory situation as to control and a negative answer indicates a bad or weak situation. Some of the questions relate to simple facts, such as whether the employees who process suppliers' invoices have access to cash or to inventories. Most of the questions, however, relate to the auditor's opinion as to the examinee's accounting in certain respects, and are designed to make him think about the possibilities before expressing himself. For example, one question is as to whether the preparation of sales invoices is controlled to prevent errors and irregularities. The explanatory material referred to above sets forth some of the more usual means of obtaining effective control over various functions and records, and is intended to aid the auditor in formulating answers to questions of this kind. The form has a liberal supply of blank space, for explanations, suggestions, and other uses.

Space is provided for the auditor to express his over-all conclusions concerning the internal control as to each

activity of the business, based upon his findings as developed through answering the questions. In those cases where there is some weakness or lack in the internal control he is expected to state the respects in which this is the case, identifying the specific procedures followed by the examinee which are not good, or the points in the examinee's routine where the control is weak or lacking, and identifying also the accounting records involved, upon which attention may need to be focused in selecting the audit procedures and determining the extent of tests.

Where the use of the questionnaire is feasible in smaller organizations it usually is filled out as far as practicable at the outset of the engagement. In larger organizations it may be filled out part by part, in each case just prior to and in conjunction with taking up the related audit work in respect of a given activity of the business.

Supplementing the Questionnaire

In any case, the auditor must satisfy himself, not only by careful inquiry, but also by inspection of the records, and as far as practicable by actual observation of the procedure, as to the routine actually employed. Knowledge acquired by questioning the examinee's employees at the outset of the work should be considered subject to substantiation by other means as the examination progresses. It is not sufficient to accept a casual explanation of the routine followed.

The auditor also must consider the probability of changes in routine and personnel during the period under examination, including temporary changes due to vacations and other absences of individuals. It is not enough to accept only a description of the situation existing at the time of taking up the work.

In evaluating the effectiveness of internal control for the purpose of deciding upon the extent to which various audit procedures should be applied, the auditor should be concerned not only with possible combinations of duties which would permit concealment of irregularities singlehanded, but also with the possibilities of collusive action. He should consider also the possibility that important errors might exist in the records, which, although not due to fraud, might result in inaccurate or misleading financial statements.

In investigating the various routines and procedures, the auditor should consider carefully the extent to which unusual or infrequent transactions are controlled. For example, there may be adequate controls over regular sales of merchandise but virtually none over occasional sales of damaged or obsolete items, waste, salvaged materials, etc., which may be likely to involve currency receipts. There also may be well-established procedures for controlling disbursements in payment of vendors' invoices, but these procedures may not be applied to disbursements representing transfers between banks, expense-fund advances and reimbursements, loans to employees, etc.

The auditor must exercise a high degree of judgment in analyzing the effect of any deficiencies in control. In each case where the situation is not good, he must consider carefully the possibilities of irregularities or errors being perpetrated in view of the practical aspects of the situation and the existence of any alternative controls. For example, a theoretically bad situation exists if the person who prepares sales invoices also has access to cash, but there need be no particular concern if the cash to which such access is had consists of a small petty cash fund, or even if it consists of incoming collections provided such collections have been listed for control and there is adequate independent accounting for the sales invoices. Furthermore, bad situations will occasionally appear to exist as the result of a bookkeeper's participating in the performance of several accounting functions by virtue of preparing several different records on mechanical bookkeeping equipment. This situation is not necessarily bad if there are adequate controls over the use of the equipment.

An important consideration in the evaluation of a system of internal control is as to whether the prescribed procedures are effectively carried out; that is, whether the records are adequate, whether the employees (including supervisory personnel) are competent, and whether errors, discrepancies, and other irregularities developed during the work are properly followed up. The auditor should consider whether the duties and responsibilities of the various departments, as well as those of individual officers and employees, are clearly fixed and defined, whether officers and employees are required to take vacations annually, and whether accounting employees are rotated where practicable. He should consider whether irregularities might occur where executives are also executives of other businesses or where employees known to be related to each other are in key positions. If the records appear to be ill adapted to the needs of the business, if they fail to provide essential information readily, if they are maintained in a slovenly manner, there are opportunities for manipulation that do not exist, other things being equal, where the opposite conditions prevail. In a department where the bulk of work is done by apparently underpaid, incompetent, uninterested clerical help, there are possibilities of irregularities that do not exist where the contrary is the case. A domineering supervisor may be able to impose his will on a group of below-average clerks and cause records to be manipulated to his advantage. If errors and the like are not properly followed up and corrected when they are developed, if the import of irregularities is not sensed by the employees who work on the records, latent dishonesty may be encouraged. Things such as these should be constantly in the mind of the auditor in making his survey of the system of internal control.

In order that the form be used most effectively, the contents, or the pertinent portions thereof, should be made known to the assistants performing the audit work on the related activities. The accountant-in-charge should be sure that his assistants are thoroughly familiar with the situation and the implications therein, and with the audit procedures necessary to uncover fraud which may be perpetrated or errors which may be made because of system deficiencies.

In concluding this perhaps too lengthy discussion of internal control I feel that reference should be made to the material on internal control issued by the Committee on Auditing Procedure of the American Institute of Accountants. The special report published by the Committee in 1949 and the case studies issued since that date should be familiar to all practicing accountants.

Work Programs

Standard program material intended for office-wide use may well outline the procedures for systematic tests of routine transactions, and specify the upper and lower limits to which such tests ordinarily might be expected to extend under various conditions of internal control; describe the firm's established procedures for performing certain common tasks, particularly the reconcilement of bank accounts; and indicate the general areas of the audit work usually performed in respect of the major items in financial statements, at the same time offering reminders as to specific matters within each of these areas which experience indicates might otherwise possibly be overlooked. Upon the basis of material such as this a work program can be developed for each individual engagement, details being supplied to fit the circumstances of the particular case.

Such a work program should be both specific and general. It should detail the operations to be performed and the procedures to be followed in respect of routine matters. At the same time it should cover those aspects of the work which transcend routine, and as to them it should be expressed in broad terms. For example, the work program relating to customers' receivables should include such specific instructions as are

appropriate in the circumstances as to inspection of documents, taking or checking of a trial balance of the individual accounts, confirmation of the detail balances, and similar work. But it should provide also for a broad study of the receivables, including computation and comparison of turnover rates and other significant ratios, review of the entries in the control account, consideration of the implications of any difference between the total of the details and the balance of the control, and so on.

As to form, it may be found convenient to use a wide sheet with columns for instructions as to the work to be done, signature or initials of the accountant performing it, working-paper index, and remarks. Intelligent use of the space for remarks may sometimes obviate the preparation of a separate analysis or memorandum. Staff accountants usually prefer to have the instructions in such form that they can sign or initial the work program as the various audit steps are completed; this means that each instruction should cover only one operation. In wording the instructions, clarity and succinctness are important. I think it is worth while to give attention also to grammatical construction and the use of words: this is one of the instances in which the audit work can be used to advantage to improve one's ability to write.

If the work program is to be used at branch locations by other offices of the firm or by correspondent firms, special care in its preparation is desirable. In this event some explanatory matter usually is in order. This should include a brief description of the examinee's business and organization and of the accounting arrangements between the branches and their headquarters, in order that the auditors at the outlying locations may understand readily how their work is expected to fit into the whole. It may include also comments on the general scope of the examination, time of performing the work, form of the working papers, report requirements, time records, procedure to be followed in the event irregularities or other unusual conditions are encountered, and similar points.

In a repeat engagement the work program may be based upon the one for the previous examination, but only after consideration anew of the former procedures in the light of conditions as they now exist. One of the worst sins an auditor can commit is to copy blindly the preceding year's working papers. In a new engagement the work program may have to be developed a few steps at a time, although in most cases the principal should be able at the outset to sketch out the major operations even if he leaves some of the details to be filled in later.

I might mention a few other points which the principal should have in mind in developing the work program although I do not have the time to discuss them. One is the desirability in some situations of rotating the audit coverage from period to period, emphasizing now one detail of the examinee's accounting and later another, so that in the course of several years all have been given close attention. The second is the form of the working papers; in some instances *pro forma* analyses may be prepared in advance for the use of the staff, especially on branch examinations. The last is the desirability of estimating the time requirements and preparing a time budget.

In concluding this part of my remarks I should like to emphasize that any formal work program should be regarded as a guide. Although it should be expected that specific requirements would be carefully observed in respect of those items where uniformity is essential (as in the case of information required of branch locations for consolidation and report purposes at headquarters), it should never be expected that the instructions should restrict in any way the intelligent application of sound auditing procedures. If conditions are encountered during the examination which indicate the necessity for

revising the work program appropriate changes should of course be made.

Review of Working Papers

I shall leave planning now, and discuss briefly some aspects of review. In doing so, however, I should like to point out that in practice one does not usually proceed from planning to review without devoting some time and effort to supervision meanwhile. You do not hand one of your staff seniors an outline of what you think he should do on an audit and send him out to do it, and then dismiss the whole thing from your mind until he places the completed working papers and draft report on your desk some time later.

It is desirable to review the working papers and the report in the examinee's office. If the reviewer raises a question the answer to which is not apparent in the working papers, or if he thinks some additional work should be done, the matter can be disposed of with greater convenience and with less embarrassment before the staff leaves the field location. If, as frequently happens, there are some points which the principal himself wants to take up with the client, he can do this in conjunction with his review of the audit work.

It is desirable also to conduct the review in the presence of the accountant-in-charge. No matter how careful the latter may be in the execution of the examination, there almost always is a question to ask, a point to discuss, or a suggestion to make in connection with the review.

The working papers should be reviewed completely, systematically, and critically by a person who is qualified to determine whether the engagement has been properly executed. This generaly is done in connection with the review of the report and by the same person who reviews the report. Usually he is the principal responsible for the engagement, but the principal may delegate the review, or part of it, to another person provided the latter is qualified to determine whether or not the field work as evidenced by the working papers has been properly performed and that the report covers all matters which the working papers indicate to be necessary.

Review of the working papers comprehends the following essentials, but these are not to be considered as the only matters to which the reviewer must give his attention:

- Examination of the internal control questionnaire and the work program to see that they have been properly completed.
- Examination of the trial balance of the general ledger and any related grouping or assembly sheets to see that each item shows that it has received the necessary attention and that the statement classification of major items is correct.
- Consideration of any adjustments applied after the trial balance of the general ledger was taken.
- Consideration of each analysis or schedule.
- Ascertainment that the firm's customary certifications have been obtained.
- Reading of excerpts from minutes, contracts and agreements, and similar documents.
- Consideration of comments noted in the papers by the staff accountants.
- Ascertainment that no questions or criticisms have been noted which have not been satisfactorily disposed of in the record, and that the papers are in order for permanent filing.

The degree of detail in which the review is carried out depends somewhat upon the manner in which the work was planned at the outset and the extent to which the accountant-in-charge and his assistants were supervised during the course of the examination. If the planning was sketchy and the supervision was light, the review has to be detailed.

The quality of the staff executing the work also has a bearing on the extent of the review. The papers of a thoroughly experienced man who is well known to the reviewer do not require as close attention as those of a less experienced accountant who has only recently joined the staff.

In any event, the reviewer should not regard the process as a clerical job, to be performed in a perfunctory manner, but should approach it with a lively imagination, for only in that way can he accomplish the purpose of the review, which is not only to detect deficiencies,

inconsistencies, and obscurities in the papers, but also, in a broad way, to determine whether or not the accountant has made the most of the opportunities afforded by the engagement to give the best possible service to the client.

It is not appropriate, of course, for the reviewer to audit the auditor to the same extent that the auditor audits the client. A staff accountant making an independent reconcilement of a bank account would not think of accepting a list of outstanding checks presented to him by the bookkeeper without footing the list. The reviewer, on the other hand, would not think of footing any such list included in the staff accountant's working papers. This does not mean that at times the reviewer should not supplement his consideration of the working papers by questioning the members of the staff in order to assure himself that their procedures have been thorough.

As the reviewer goes through the working papers he should have in mind the accumulation of suggestions for the next examination. No set of working papers is perfect. At least I have never seen one that I thought was perfect. In the light of hindsight, it frequently will appear to the reviewer that possibly certain things might well have been done differently. He should make notations of such things, preferably on a separate sheet of paper, and place it where it will come to attention when the work is planned the next time.

The reviewer should indicate the performance of his work in some appropriate manner. I have followed the practice of initialing the principal parts of the working papers, such as the general ledger trial balance and related grouping or assembly sheets, record of adjusting entries, summary sheets on analyses and schedules, excerpts from the minutes, and so on, but not every page of the underlying details.

In concluding the discussion of this topic it may be noted that the same considerations which guide the principal in reviewing the work as a whole should also guide the accountant-in-charge in his review of the work done by his assistants.

Report Review

The first task of the report reviewer is twofold. It is to see that the report is adequately supported by the working papers and that the report contains all necessary disclosures indicated in the working papers. In connection with the financial statements he will check the figures into the papers, see that the captions are proper, and that any necessary explanatory notes are appended. As to any commentary material, he will see that all statements of fact are supported by the papers and will pass on any expressions of opinion. As to the certificate, he will consider the necessity for any explanation or qualification. If the report contains numerous schedules and comments in addition to the main exhibits and a certificate, he may delegate much of the detail reference checking to a staff accountant or an office assistant, assuming the checking operation does not require the exercise of judgment, for example as to whether underlying details have been properly assembled and resulting totals are properly captioned. The checking of references from one part of the report to another is performed in most offices in connection with the typing of the report.

The report reviewer is concerned with the form of the report as well as with its substance. He should be attentive to expression, grammatical construction, and all the other points that need to be watched if the report is to be a good one instead of a poor one.

I have already mentioned the matter of auditing standards of reporting. The report reviewer must be familiar with these standards and see that each report conforms with them. He should have in mind also the Statement on Auditing Procedure (No. 23) issued by the Institute Committee, entitled "Clarification of Accountant's Report When Opinion is Omitted." This subject has been widely discussed in professional magazines during the past year or two and I am sure all of you are familiar with it.

If the audit has disclosed any situation as to duties, procedures, or condition of records which is conducive in any important respect to the perpetration or concealment of fraud, or to the existence of material errors in the records which might result in inaccurate or misleading financial statements, the reviewer should consider the desirability of bringing the matter, together with any practicable suggestions for improvement, to the attention of the client in the comments of the report or in a special letter.

It almost always is desirable to review the report with the client before releasing it. This preferably should be done by the principal responsible for the engagement, or by a partner of the firm if the principal is not a partner. Such review does not mean, of course, that the auditor should in any way compromise his independence by permitting the client to dictate what he says in his report.

I recognize that the foregoing is the merest outline of the points to be considered in reviewing a report. To carry the matter further, however, would involve a discussion of report technique, which is a very large subject in itself and one that is without the scope of this article. Consequently, I shall stop here.

Tax Decisions of 1951

(Continued from page 89)

able and disallowed in part, the court ruled that the excessive portion was not a gift and hence remained fully taxable to the recipients.

(*Irma and Aida Smith* v. *Manning*, (CCA-3) May 28, 1951.)

"Kickbacks" by opticians to oculists were held not deductible as contrary to public policy. This case will be reviewed by the Supreme Court.

(*Thomas and Helen Lilly* v. *Commissioner*, (CCA-4) April 2, 1951.)

A personal holding company on the cash basis may deduct the Federal income taxes paid *and* incurred in the taxable year.

(*Birmingham* v. *The Loetscher Company*, (CCA-8) April 11, 1951.)

Where a cash-basis taxpayer sells property and does not receive notes or other negotiable evidence of indebtedness but merely the vendee's contractual obligation to make deferred payments, the taxpayer may report the profit as the payments are received, first as recovery of cost, and the excess as gain.

(*Nina J. Ennis*, 17 T.C., No. 51; Sept. 27, 1951.)

A partner is entitled to the benefits of section 107 in computing tax on his share of lump-sum income for partnership services rendered in part prior to his admission to the firm.

(*Commissioner* v. *Elder W. Marshall*, (CCA-3) Dec. 21, 1950; *Commissioner* v. *Sigvold Nielson*, (CCA-9) Feb. 7, 1951; *G.C.M. 26993.*)

A decision which may prove of serious consequence to many taxpayers and their tax representatives is *Andrew Jergens;* 17 T.C., No. 94; Nov. 21, 1951. It was held therein that a corporate officer may not deduct entertaining expenses incurred by him personally and not reimbursed by his corporate employer. This finding might be avoided if an employment contract or the corporate minutes indicated clearly that it was the mutual contractual understanding that the compensation paid included such expense reimbursement.

Where the taxpayer was in financial difficulties and arranged a settlement with its creditors so that they accepted less than the face amount of their claims and canceled the balance, it was ruled that these were business dealings and that each cancellation was the result of each creditor's business judgment and was not a gift. As a consequence, the forgiven portion of the indebtedness was deemed taxable income.

(*The Marshall Drug Company* v. *U. S.*, U. S. Court of Claims; March 6, 1951.)

Book Publishing Accounting

By JAMES J. O'DONNELL, C.P.A.

This paper outlines some of the more important accounting problems of book publishers, including printing medium costs (plant) and the amortization thereof, inventory control, royalties, and title accounting. It will be very helpful in orienting those with no previous experience in this field.

BOOK publishing is one of the principal industries in the Graphic Arts group. In the broad sense, any producer and distributor of a book may be classified as a book publisher. The major sources of books are commercial publishers, university presses and government agencies. We are particularly concerned with the commercial publishers which are by far the largest in number and the most diversified in activity. As in any large industry, specialties have developed. Publishers of original publications are classified into trade, educational, juvenile, scientific, technical, sport, religious, and other groups. The term, "trade", generally includes the fiction, non-fiction, poetry and plays found in the average bookstore.

Most publishers departmentalize their operations when sales volume and publication lists in two or more groups reach sufficient proportions. Book clubs and reprint houses are not usually publishers of original editions.

Publishers of original editions must select, edit, produce, advertise, promote, sell and ship their respective publications. Generally, publishers contract with specialists outside their organization in matters pertaining to production and distribution. For example, among the creditors and vendors we find authors, special editorial readers, translators and indexers, compositors, printers and binders, advertising agencies, job printers, selling agents, shipping concerns, and sometimes management contractors.

One of the difficult parts of book publishing is creating and maintaining a satisfactory list of new publications season after season. "Quick turnover" books, "back list" books and a publisher's pride of product are basic considerations to bear in mind in evaluating a satisfactory publication list. However, the emphasis is on the individual title. Each title published is a distinct product. The "break even" point of books sales by titles and, of course, in total varies among publishers. For a satisfactory profit there must be titles that sell quantities substantially in excess of the "break even" point. With some exceptions, it is from the better selling books that income from subsidiary rights is received, including:

Reprints
Serialization
Book club selections and premiums
Movie and dramatic rights
Royalties (usually foreign editions)
Selection permissions

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This paper was presented by Mr. O'Donnell at a technical meeting of the Society held at the Engineering Societies' Building on May 24, 1951, under the auspices of the Committee on Graphic Arts and Allied Industries Accounting.

Operating Income and Gross Profit

It is from the two sources of operating income, namely, the gross profit on books sold, and income from subsidiary rights, that all operating expenses must be deducted to arrive at net operating income. Some organizations prefer to deduct all operating expenses from the gross profit on books sold and then add income from subsidiary rights to arrive at operating income, and others prefer to allocate operating expenses between the two sources of income. There is nothing sacred about classifications, or the form of statements designed. Reasonable modifications may be used to meet conditions peculiar to each concern. However, consistency from year to year is important and there are obvious advantages in conforming to custom and tradition in the trade when comparing percentages with others in the publishing industry.

Among publishers the gross profit on books sold is almost universally considered to be the amount obtained by subtracting from the net sales the sum of (1) the manufacturing or production cost of the books sold, (2) the royalty applicable to the books sold, and (3) the plant expense.

Very few publishers operate, own, or control book manufacturing facilities. Instead, purchase orders, applicable to each phase of the production process, are issued to associated industries including die makers, engravers, compositors, printers and binders. The production process results in the publisher acquiring the printing medium (plant), and merchandise (books and printed sheets).

Printing Medium (Plant)

The accounting treatment of plant requires some extended comment. The cost of plant includes all the direct charges incurred in producing the completed printing medium for the first edition. A separate cost record should be maintained for each title. Among the charges to plant are expenditures for special editing and translation fees, art work, illustrations, dies, cuts, engravings, composition, extra page proofs, authors' alterations, plates, and copyright fees. The principal amounts charged to plant usually consist of composition and plate charges. Plant, especially plates, has some intrinsic value until subsequent edition, license and rental possibilities are exhausted.

While some publishers charge off plant purchases currently or include them in the cost of the first edition, the usual practice is to capitalize costs to date of publication and write them off in the month of publication, or through extended amortization charges. The amortization charge is usually computed on a time basis, based upon sales experience with similar publications. For example, a publisher may elect to reduce capitalized plant to the estimated metal value of plates, as illustrated by the following formulae:

Fiction		Non-Fiction		Non-Fiction	
1st Month—	35%	1st Month—	30%	7th Month—	5%
2nd " —	20%	2nd " —	15%	8th " —	5%
3rd " —	15%	3rd " —	10%	9th " —	5%
4th " —	10%	4th " —	5%	10th " —	5%
5th " —	10%	5th " —	5%	11th " —	5%
6th " —To Metal Value		6th " —	5%	12th " —To Metal Value	

The plant costs of special non-fiction titles which are expected to have a longer life may be amortized accordingly over a longer period.

The method selected should be consistently followed.

When plant costs are capitalized, unpublished plant and unamortized plant amounts should be shown in the non-current section of the balance sheet. The portion charged off to plant expense should be shown in the cost of books sold section of the income statement.

The gain or loss from the sale of plant is treated similarly to sales of capital assets.

Production Costs and Inventories

Cost records used to accumulate the direct cost of plant by title may also be used to determine the direct production cost of printed sheets and bound books. Production costs include paper, printing, cloth binding, and jacket or wrapper charges. Perpetual inventory control methods are used to control paper, cloth, printed sheet and bound book inventories. The unit cost of printed sheets is the sum of paper and printing costs divided by the quantity printed. The unit cost of bound books is the sum of the unit cost of printed sheets and the unit cost of binding. A new unit cost is established for each printing and each binding.

On the income statement, the total production cost is the sum of the opening inventory and total purchases of paper, printing and binding reduced by the cost of gift copies (which is usually charged to promotion or selling expense) and the closing inventory. Inventories are usually stated at the lower of cost or market. For management, comparative and statistical purposes the write-down of the closing inventories is frequently shown on the income statement as a separate item.

It is appropriate at this time to elaborate on the internal control of inventories by quantity and by location. Paper, cloth and printed sheet inventories are usually on the premises of several printers and binders. Bound books remain in the possession of binders until forwarded to the publisher's office or shipping room, shipping service warehouse or consignment depositories. Perpetual inventory control records must be maintained to show the quantity of paper and cloth, and printed sheets or bound books of each title, available at each location.

It is an accepted auditing procedure to obtain written confirmation of quantities from reputable printers, binders, independent warehouses and consignment depositories. Binderies should be requested to indicate the billing stage of the inventories confirmed. For example, it is not unusual to find books physically bound for which binding charges have not been billed to the publisher. Unbilled binding charges on completed binding orders should be accrued at the end of the accounting period, or the approximate unbilled amount should appear as a footnote on the balance sheet.

Royalties

When a publisher agrees to publish the work of an author, the publisher and author enter into a contract in which the publisher agrees to compensate the author by paying either a royalty on (1) books sold, (2) book stock disappearance, (3) quantity printed, (4) share of the profits or (5) a lump sum. Paying royalty on books actually sold is the method most generally used.

Royalty advances are made to authors on or before, usually before, publication date based on estimated royalties to be earned on a specific book, specific books or on general account. Charges are sometimes made to authors' accounts for certain editorial, manufacturing and promotion costs if specifically provided for in the royalty contract. Royalty advances on published and unpublished books should be shown at their realistic value in the non-current asset section of the balance sheet. Frequently, advances are, in effect, minimum guarantees to the author and unless sufficient royalties are earned unrecovered balances must be written off.

Royalty contracts often contain graduated rate clauses wherein the royalty rates increase after a specific number of books are sold. The rates also vary on regular, mail order, special and remainder sales and as to sales to domestic, Canadian and other foreign markets. The rate may be applied to the catalog list price, a net wholesale price

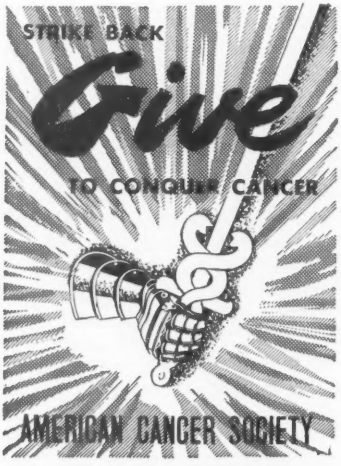
at a specific discount or on the net amount of publisher's charges. The calculation of royalties therefore requires carefully classified and somewhat detailed tabulations of sales. To assure the accountant of the reasonableness of quantities recorded for royalty purposes, sales records should reconcile to inventories. The total royalty applicable to the books sold should be charged to royalty expense and appears in the cost of books sold section of the income statement. Credits to authors' accounts for royalties earned either reduce the advances or establish a current liabiltiy for royalties payable. Frequently, an author's portion of receipts from subsidiary rights is credited directly to the author's account.

Each author's account is summarized at regular intervals and a royalty statement of the transactions and balance is submitted to the author.

Title Accounting

Because each title published is, in many ways, a separate venture, it is essential for management to know the results of operations by individual titles. The proper and careful preparation of title accounting records are the means of obtaining this information. This record should show for each title published, the total income (from book sales and subsidiary income), and the total direct chargeable costs and expenses. The extent to which all costs and expenses are recorded may vary somewhat, but they should include the total costs of plant, paper, presswork, binding and the total royalty earned (or author's advance if that is greater). Other expenses directly chargeable to particular titles are the cost of gift copies, space advertising, and special circulars, posters, and dummies.

In evaluating the significance of the final figure shown on title accounting records, careful consideration should be given to editorial, shipping and other expenses generally classified as overhead, the future income possibilities, and the potential value of an author. Title accounting records have been found to be a very useful guide to publishers, especially during periods of rising costs and material shortages, so that the publisher will be in a position to adjust the list price to obtain a reasonable profit on each specific title.



New York State Tax Forum

Conducted by BENJAMIN HARROW, C.P.A.

Medical Expense and Contributions—Limitations

UNDER the New York State income tax law a deduction from gross income is permitted for medical expenses. Only medical expenses in excess of 5% of the net income are allowed as a deduction and the maximum deduction may not exceed $1,500 for a husband and wife filing a joint return. One of our members wants to know if the net income upon which the excludible portion of 5% is computed includes capital gains.

In 1938 the law relating to the taxation of capital gains was amended. Such gains are now taxed separately. For that reason Article 21 of the Regulations provides that gross income does not include capital gains. Sec. 359 of the law which defines gross income provides that the term gross income shall not include capital gains. On the basis of the law and regulations, therefore, the excludible portion of the medical expense would be based upon net income exclusive of capital gains.

The deduction for contributions is limited to 15% of net income. This limitation likewise would not be based upon any capital gains. After the law had been amended in 1938 so as to tax such gains separately, a series of questions and answers was promulgated by the Tax Commission. Question 16 read, "Are charitable contributions deductible in the computation of net capital gain?" The answer was "No. They are deductible only from gross income in an amount not in excess of 15% of net income."

Capital Gains and Losses

The 1951 Revenue Act now makes it possible to utilize 100% of a net long-term capital loss. Such loss may be offset 100% against net short-term capital gains and any balance remaining may be deducted from ordinary income to the extent of $1,000. The excess may be carried forward for five succeeding years and offset in full against capital gains or against ordinary income to the extent of $1,000. The new act approaches more closely the New York law in that 100% of a loss, long- or short-term, is taken into account under the New York law. No deduction however is allowed against other income, but a carry-over in full is permitted for five years to be offset against any capital gains in those years.

Optional Deduction

A deduction equal to 10% of gross income, but limited to $500, is allowed in lieu of all allowable deductions, under the State income tax law. This provision does not work as liberally as the standard deduction under the fed-

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eral law. Under the state law the optional deduction replaces all business deductions as well as personal deductions. In the case of an individual who changes his residence during the year and who files both a resident and a non-resident return, the optional deduction may not be used.

It has been suggested that the optional deduction be allowed in addition to all business deductions. In the case of a change in residence, it has been recommended that the optional deduction be allowed on the resident return on a prorated basis.

The New York law makes the optional deduction irrevocable for the particular taxable year. The 1951 Revenue Act now makes the standard deduction revocable within the statutory period of limitations. A similar provision for the optional deduction is recommended.

Capital Assets—Section 117(j)

Under the Internal Revenue Code, property used in trade or business as to which the law permits a depreciation allowance, and real property used in a trade or business, are not included in the definition of capital assets. However a gain resulting from a sale or exchange of such assets if held for more than six months, may be treated as a capital gain. The effect of this provision is to give a taxpayer the benefit of full deduction of a loss against ordinary income, and to give him the benefits of capital gain treatment in the event of a gain. The New York State law does not have a comparable provision. Under the state law (Sec. 350) the term "capital assets" does not include business realty or depreciable business property. Gains on such assets would be fully taxable and losses fully deductible. It has been suggested that the Tax Commission approve a change in the law adopting a provision comparable to Sec. 117(j). The Commission has not favored such a change.

Net Operating Loss Deduction—Franchise Tax

Under Art. 9(a) the starting point for entire net income is the net income reported for federal income tax purposes. One of the adjustments to federal net income required under Sec. 208.9(b) is the elimination of any net operating loss deduction. It is now well recognized that the deduction of a net operating loss is a sound and equitable provision for taxing income of a business. The artificial one-year basis of taxation of income, while practical and necessary for raising revenue, is not valid economically. The net operating loss deduction cures this major inequity by spreading the income over an economic cycle if a business does not show a profit each year.

It would seem that a similar provision should be a part of the franchise tax law, but the Tax Commission has never looked with favor upon any suggestion for allowing a deduction of a net operating loss in determining entire net income. Undoubtedly there would be a loss in revenue, but a sound tax policy favors such a provision even if it means an increase in the franchise tax rate should the loss in revenue be too great. It is suggested that the Tax Commission undertake a study of the effect on the revenue of such a deduction to determine how much might be involved in a typical year.

Allocation of Receipts

Under the receipts factor, a sale is allocated to New York if the property is located in the state, either at the time the order is received or at the time the property is appropriated to the order. In the latter case it is immaterial where the order is received (Reg. Art. 413.1).

There has been some criticism of the emphasis given to the location of merchandise at the time it is appropriated to an order. The suggestion has been offered that more weight be given to the place where the sale is negotiated or the place where the merchandise is

shipped. We understand that the Tax Commission is presently studying this situation.

Subsidiary Capital

If a corporation owns more than 50% of the stock of any corporation, the latter is defined as a subsidiary and the investment in such subsidiary is defined as subsidiary capital. Such capital is not subject to the one mill tax on total business and investment capital. Subsidiary capital is separately taxed at the rate of one-half mill on the first 50 million dollars, and then only on that portion of subsidiary capital allocated to New York. The allocation is determined by the franchise tax report filed by the subsidiary company for the preceding year. Sec. 210.7 provides, however, "that the portion of the taxpayer's subsidiary capital to be allocated within the state shall be not less than fifteen per cent . . ."

Where the subsidiary capital allocated to New York is less than 15% under the statute a taxpayer may establish "to the satisfaction of the Tax Commission" that such is the fact and that less than 15% of the corporation's activity with respect to the subsidiary is conducted within the state. That is not an easy task and the 15% floor on subsidiary capital is in many cases too high. So far as we know this percentage is rarely reduced.

It has been suggested that a floor on subsidiary capital of from 5 to 7½% would be more realistic. The Tax Commission is not in agreement with this suggestion.

Gross Receipts Tax—Refunds

A taxpayer who has endeavored to obtain a refund of a Gross Receipts tax payment erroneously made, often experiences exasperation or even despair. Perhaps it is really the fault of the law. If that is so, then it is suggested that the Comptroller of the City of New York recommend changes in the law and the procedure for refunds in the interest of fairness to taxpayers. The law should be made as palatable as any tax law can be.

The Administrative Code (Sec. B 46-5.0) provides that a tax erroneously, illegally or unconstitutionally collected shall be refunded or credited. Application for a refund must be made within one year of payment. We have no quarrel with this provision. But the Code provides that no claim for refund will be entertained unless the tax was paid "under protest, in writing, stating in detail the ground or grounds of the protest." But suppose the taxpayer is not aware at the time he pays the tax that he has overpaid it. It is almost hopeless for him to obtain a refund under those circumstances. He must then squirm and twist the facts in his case in order to come within the tiny loopholes that might enable him to get the refund to which he is justly entitled. He must show that the overpayment of tax was due to a mistake of fact. Generally, such mistakes are errors in computations or footings or errors in transcribing figures from original records to the tax return. The failure to take allowable deductions and the failure to exclude non-taxable receipts are mistakes of law and such mistakes cannot generally be corrected unless the return was filed under protest. These are the mistakes that a taxpayer may not detect until after the return has been filed. He must then try to convert a mistake of law into a mistake of fact, a Houdini-like feat. Such a situation really has no place in a tax law.

A recent news release suggests a proposed increase in the gross receipts tax rate with some reduction in the sales tax. This is an appropriate time to correct the procedure and basis for obtaining refunds of taxes erroneously paid.

Involuntary Conversion

Sec. 354.4 of the income tax law provides that no gain or loss shall be recognized as a result of a compulsory or involuntary disposition of property,

provided the taxpayer forthwith and in good faith acquires similar or related property. The taxpayer may also meet the provisions of this section if he acquires control of a corporation owning the similar or related property.

To cover situations where it is not practicable for a taxpayer to acquire similar property forthwith, the law and Regulations (Art. 493b) provide that the taxpayer may obtain permission to set up a replacement fund in which the proceeds received as a result of the destruction, theft, seizure or condemnation of his property are held. In the application to the Commission to establish such a fund the taxpayer must "recite all the facts relating to the transaction and declare that he will proceed as expeditiously as possible to replace or restore such property." In addition, the taxpayer will be required to furnish a bond in an amount not in excess of twice the estimated additional income taxes that would be payable if no replacement fund were established.

There are similar provisions in the Internal Revenue Code governing the non-taxability of a gain resulting from involuntary conversions. After the Revenue Act of 1951 was passed Congress passed an amendment to I.R.C., Sec. 112(f), making the provisions of non-taxability applicable to situations where similar or related property is acquired before the proceeds are received for the property involuntarily converted. No similar provision is found in the New York law.

We were recently asked for an opinion on whether a taxpayer would be required to obtain permission of the Tax Commission for establishing a replacement fund, if such permission had already been obtained from the Commissioner of Internal Revenue. There is no provision in the New York law exempting a taxpayer from the requirements of the law or regulations based upon similar provisions in the federal law. There is every likelihood that the Tax Commission would give its consent to set up a replacement fund if the Commissioner of Internal Revenue had done so. The federal and state laws involve separate jurisdictions and one is entirely independent of the other. In the matter of the replacement fund, the State safeguards its revenues by requiring the taxpayer to furnish a bond. It might mean the loss of revenue to the State for a taxpayer to ignore this provision. Under the circumstances the provision in the law in our opinion would be strictly construed.

Reclassification of a Real Estate Corporation

A real estate corporation is taxable under Sec. 182 of Article 9. This classification is more favorable taxwise than one under Article 9A and requirements for classification as a real estate company must be strictly adhered to. For example, if a real estate corporation is controlled by a business corporation and the property of the real estate corporation is used or occupied by the business corporation, the real estate corporation becomes a business corporation taxable under Art. 9A. Again, if more than 10% of the average gross assets of a real estate corporation consist of stocks, bonds or loans to wholly-owned subsidiaries, the corporation loses its status as a real estate corporation and becomes taxable as a business corporation.

It may become important to determine just when a change of classification occurs. Is it when there has been a change in the activities of a corporation, even though the Tax Commission is not then aware of such change, or when the Tax Commission takes some action on the basis of its audit of the tax return? This question was before the court in the *Norembega Co.* case.[1] In this case the taxpayer argued that its classification had automatically changed when the nature of its business had changed. It happened that in that year the franchise tax law on real es-

[1] 3 F. Supp. 500 (1933).

tate corporations had been changed by adding the 2% tax upon a surplus at the time of a change in classification. If the taxpayer's contention was valid it would not have been subject to the 2% tax, since the change in classification would have occurred prior to the enactment of the new provision. But the court held that the change takes place when the Tax Commission so determines.

A later case[2] seemed to cast some doubt on this holding. In this case, which arose under old Article 9A, a real estate corporation had changed the nature of its business on November 22, after the commencement of the franchise tax year (November 1st, under the old law). It was held that the corporation was not required to file a return as a real estate corporation for the year in which the change occurred, and it was not required to file a return under Article 9A until the following year. The court held that when a corporation which was wholly engaged in the purchase, sale and holding of title to realty for itself, purchased stock of an investment company which the corporation thereafter held for business purposes, it ceased to be a "real estate corporation" and *ipso facto*, without legal proceeding, became a "business corporation" and was not thereafter liable for franchise tax imposed against real estate corporations. Of course, under new Article 9A,[3] the base year and privilege year are now the same, and the corporation would be required to file a return as a business corporation for the year in which the change occurred.

Unincorporated Business Tax—Allocation

If a business is carried on within and without the state, only the New York business is subject to the Unincorporated Business tax. It is noteworthy that the first method of allocating New York business given in the Regulations (Question 77) may be based upon the books of the business if they are "so kept as regularly to disclose the proportion of income earned within this state, . . ." The second basis given in the Regulations is one that has the approval of the Tax Commission.

The third basis of allocation is the use of a formula consisting of three factors: real and tangible property, payroll, and sales. A recent amendment to the Regulations (Questions 79 and 81) clarifies the sales factor where this relates to charges for services. Charges for services are to be allocated to New York if the services are "performed by an employee, agent, agency or independent contractor chiefly situated at, connected with, by contract or otherwise, or sent out from offices of the unincorporated business, . . . situated within the state."

Unincorporated Business Tax—Allocation for Security Brokers

An amendment to the Regulations (Question 82(a)) now requires security and commodity brokers doing business within and without the state to allocate commissions on the basis of a fixed percentage. If the order originates at a bona fide established place of business outside the state and is then received at the New York office for execution on a New York exchange, 40% of the commission is allocated to New York and 60% outside the state. If the order originates at the New York place of business and is then transmitted to a bona fide office of the broker for execution on an exchange located in another state, 60% of the commission is allocated to New York and 40% outside the state.

Non-Residents—Allocation Under the Income Tax Law

Non-residents doing business within and without the state may allocate their income. This applies also to a New York partnership with a non-resident member, provided the partnership car-

[2] *Unum Real Estate Corp.* v. *Tax Commission*, 281 N. Y. 844 (1939).
[3] Laws of 1944, Chapter 415.

ries on business within and without New York. The allocation provisions relating to the unincorporated business tax and the amendments mentioned above are equally applicable to the income tax on non-residents. The amended Regulations are Art. 457, clarifying services in the allocation formula, and Art. 471, relating to the apportionment of commissions received by brokers dealing in securities and commodities.

Change of Residence During the Taxable Year

A non-resident becomes a resident during the year. While a non-resident he earned some income which he realized during the period of his residency. Is such income, the taxpayer being on a cash basis, subject to tax in New York?

Article 524 of the Regulations probably covers this situation. The Regulation applies to situations where "an individual changes his status from that of a resident to that of a non-resident *or from that of a non-resident to that of a resident* . . ." Two returns are required. "The return for the period prior to the change shall include . . . all items of taxable income received by *or accrued* to the taxpayer up to the date of his change in status. In other words the return shall be made on the accrual basis irrespective of whether that be his established method of reporting."

According to the Regulation all income accrued to the individual up to the time he became a resident would not be subject to tax, since under the facts it was not earned within the state. It should be noted that where a resident becomes a non-resident during the year, he cannot escape the tax on any income earned in New York before the change in residence. It is reportable on the accrual basis. Apparently the same procedure is applicable to the non-resident who becomes a resident during the year.

Treatment of Treasury Stock under the Franchise Tax Law

Lawrence B. Spirer sends us an interesting question regarding the includibility of treasury stock as an asset in computing business capital. He points out that Article 331 of the Regulations excludes treasury stock as investment capital. If it therefore constitutes business capital he poses the question of whether it constitutes an asset of a corporation. He calls our attention to two decisions under the federal law. In the first case,[4] the court said: "Indeed the only difference between a share held in the treasury and one retired is that the first may be resold for what it may fetch on the market, while the second has disappeared altogether. * * * They (treasury stocks) are not a present asset, because as they stand, the defendant (the corporation) cannot collect upon them. What in fact they are is an opportunity to acquire new assets for the corporate Treasury by creating new obligations." In the second case,[5] the court said: "In our opinion it is an exceedingly doubtful theory that reacquired stock such as is involved here is to be treated as 'property' in the way that stock of another corporation held in a corporation's assets is property."

In our opinion treasury stock would constitute business capital. Under old Article 9A the one mill tax was levied against issued capital stock and this included stock issued but reacquired by the corporation. In the *Borg* case, referred to by Lawrence Spirer, the court at one point says, "The mere acquisition of stock does not operate to retire it or to impose any obligation to retire it. It was *an asset* and the company could have sold it." Until the stock is actually retired by the corporation through formal proceedings required by the corporation law of the state it remains issued stock and the Tax Commission would probably continue to consider it an asset under new Article 9A.

[4] *Borg* v. *International Silver Co.*, 11 Fed. (2d) 147 (1926).
[5] *Bruckheimer*, 46 BTA 234, Appeal to CCA2 dismissed (1943).

Notes on the New York State Unemployment Insurance Law

Conducted by SAMUEL S. RESS

THE right to a reduced unemployment insurance tax rate may depend on which of two firms can be deemed the successor to a business that has been operated for a number of years by one firm and thereafter by a second concern.

In Appeal Board Case #24,419-50, decided on November 16, 1951, the issue was determined in favor of a hotel operating corporation which had leased both the real estate and the personalty from the corporation which owned the hotel properties.

In the case at bar Hotel AB, owned by the XY Corporation, was operated by the AB Corporation, the employer, from October, 1938, to August, 1948, when the lease expired. In March, 1941, while operating Hotel AB, the AB Corporation acquired title to Hotel MN which property it continues to own at the present time. From March, 1941, to March, 1949, Hotel MN was operated by lessees who paid the AB Corporation a fixed rental plus a percentage of the profits. The AB Corporation was subject to the New York State unemployment insurance law as the employer of the help in the Hotel AB from 1938, to August, 1948. From August, 1948, to March, 1949, the AB Corporation operated no hotel but merely collected rents and met mortgage payments, paid officers' salaries, and filed quarterly unemployment insurance reports. On February 7th, 1949, the AB Corporation changed its name to the MN Corporation and commencing March 1, 1949, it undertook the operation of the MN Hotel and paid contributions on the payroll of the hotel employees.

The Z Corporation was organized in August, 1948, leased Hotel AB from the owners and commenced operating the hotel. The Industrial Commissioner issued a determination that on the expiration of the Hotel AB lease and the surrender of the premises to the new lessee (the Z Corporation) the latter was deemed the successor and entitled to the unused contribution rate credits and experience of the AB Corporation. The AB Corporation (now known as the MN Corporation), the employer in this proceeding, contested the determination and requested a hearing. The referee ruled in favor of the MN (formerly AB) Corporation. The Industrial Commissioner appealed from the Referee's decision.

The Appeal Board affirmed the Referee's decision. It held that the MN (AB) Corporation did not own the Hotel AB but operated it under a lease. When the lease expired, the hotel property reverted to the owner of the fee. The owner then granted a new lease to the Z Corporation, which thereupon commenced operation of the Hotel AB. The Z Corporation acquired nothing from the AB Corporation. It concluded that the Z Corporation was not the

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successor to the AB Corporation's experience rate credits, even though it was the new operator of the Hotel AB, and even though the experience rate credits had resulted from the operation of Hotel AB, originally.

Penalties for Failure to Comply With Reporting Requirements

If unemployment insurance taxes are not paid when due, interest is charged at the rate of ¾ of one per cent per month. Failure to receive a regular form from the State does not excuse late payment. The employer has the duty of complying with reporting requirements. If the employer fails to file a quarterly tax report and a correct report is not filed within twenty days after demand, an arbitrary assessment may be made by the Division of Unemployment Insurance, which determination will become final unless a request for a hearing is made within twenty days after the Notice of Determination is mailed to the taxpayer by the Commissioner. The Commissioner may reduce the assessment on his own motion.

The penalty for failure to file any required report of the names, social security numbers, and remuneration paid to individual employees by an employer who has been liable for contributions for less than 3½ years, amounts to $3.00 for each employee for whom reports are required. The total penalty cannot exceed $500.00, or an amount equal to 3 pecrent of the remuneration paid to the employees, whichever is less.

If the employer fails to reply within seven days after the *mailing* to him by the unemployment insurance office of a Request for Employment and Wage Data needed to determine the unemployment insurance rights of a benefit claimant, the employer is subject to a $10.00 penalty with respect to each request with which he did not comply, unless non-compliance is shown to have been due to circumstances beyond his control.

Another device, to which the Industrial Commissioner can resort in order to enforce the collection of penalties, involves the withholding of reduced tax rate notices under the experience rate provisions of the law.

In the Appellate Division decision handed down on November 28th, 1951, (*In the Matter of Metaltex, Inc.* v. *Edward Corsi, as Industrial Commissioner, Appellant*) the court reversed the Appeal Board. The issue in the case was whether the penalty imposed by the Commissioner upon an employer for failure to file a quarterly payroll report may be sustained where no report has been received by the Commissioner, although the employer claims it mailed it on time. Additional demands for reports were ignored by the employer.

A demand was made on the employer for the quarterly report due on July 31st, 1949. Upon receipt of the demand mailed by the Commissioner on August 19th, 1949, the employer advised the Division of Placement and Unemployment Insurance that the report for the quarter in issue had been mailed to the Division together with a check covering the contributions due thereon on July 27th, 1949. On August 31st, 1949, the Division enclosed new blank forms and advised the employer that no reports were on file and demanded a report within twenty days. On November 23rd, 1949, the payroll report enumerating 49 names was received by the Division which thereupon assessed the employer with a $147.00 penalty under Section 575, subdivision 2. The employer protested the penalty and demanded a hearing. The accountant for the employer testified that a check of $303.20 was mailed to the Division by the bookkeeper on July 19th, 1949. The check never cleared the bank and payment was stopped on November 22nd, 1949, the date when he mailed a duplicate report and check to the Division. The Referee held that there was evidence that the employer had mailed the report on time and set aside the

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Office and Staff Management

A forum for the exchange of views and information on all aspects of the administration of an accounting practice.

Conducted by MAX BLOCK, C.P.A.

Use of Handicapped Workers

IN a period of labor shortages one thinks of using handicapped workers. Yet it is known that such persons are often better than average workers, as reported by employers who utilize them regularly.

Accountants who are experiencing help difficulties may get some relief, and worthwhile employees, from this source. There are a number of organizations that specialize in training and placing such employees and they can be located by inquiry from any welfare agency.

A number of positions in an accountant's office could be filled by handicapped workers, to wit, typist, proofreader, bookkeeper, etc.

Client Control Form

A form recently devised by Charles A. Hadley Company for use by accountants is deserving of consideration by firms having many clients. The form is a client's record on a card with punch holes for various types of information. By a sorting process it is possible to ascertain in a few minutes what tax returns are to be prepared each month, audits to be made, and other service data. The card permits ready grouping of clients by type of business and location, and is adaptable to providing any type of control data desired. This form is described as the "Rocket System" for statistical and follow-up control.

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Improving Report Writing

The General Accounting Office (Corporation Audits Division) in Washington, D. C. has prepared a pamphlet entitled "Suggestions for Improving the Language of Audit Reports" which should be furnished to every staff member. It can be very helpful in raising report language standards and should be made compulsory reading.

Copies of the pamphlet can be obtained from the Superintendent of Documents, Washington, D. C., for thirty cents each.

New Literature

Prentice-Hall has published a book on the accountant's office entitled Accountant's Office Manual by Charles S. Rockey.

In the Journal of Accountancy, issue of December, 1951, there is an article entitled "Modern Methods of Work Simplification Can Save Time and Money in a Public Accounting Office", by Jay E. Robinson, C. P. A. The writer points out very strongly the importance of a reproduction machine in an accountant's office for making copies of reports, tax return schedules, office forms, bulletins to staff and clients, etc. Medium-size and large firms who do not have such equipment are unduly handicapping themselves. There are several good machines on the market varying in method, size and price.

Another point worthy of mention is that gray is the best desk color to

reduce eye strain and that posture chairs are beneficial in reducing fatigue.

Office and Staff Managers' Meetings

Monthly luncheon meetings have been held since last April. It can be reported that there is a nucleus of regular attendants who not only enjoy the social aspects of the luncheon but who invariably leave each discussion period with some new ideas and viewpoints.

There still is room for more members. Just drop in—no notice is required—at the Hotel Lexington, Lexington Avenue and 49th Street, on the last Tuesday of each month at 12 noon. The meeting room is listed on the hotel lobby directory.

Assignment Program

As the size of a staff increases, the mechanics of control and assignments become more complex. Where monthly audits are involved the problem is not with the original assignments but in making changes. In that event not only is one assignment changed, but like ripples in the water, one change affects other assignments and a reshuffling of men and jobs becomes necessary. In many firms this is a constant situation, varying only in degree from day to day.

Most forms in use are not suitable for easy revisions of the program. Contributions of ideas for an easily revised assignment program are solicited. If you have such a form or have an idea as to one, please mail it to the Editor of this column at the Society's office.

Notes on the New York State Unemployment Insurance Law

(Continued from page 132)

penalty. The Appeal Board sustained the Referee's decision in favor of the employer.

The Appellate Division in reviewing the findings of fact by the Appeal Board pointed out that the evidence revealed that the report had been prepared by the bookkeeper and checked by the accountant on July 19, 1949; a check had been prepared on the same day, and that they were mailed by the shipping clerk on the same day. The shipping clerk did not testify at the hearings. The accountant had testified that the bookkeeper had mailed the report and check. The president testified to the same effect. There was also a conflict as to the date of mailing. When confronted with the discrepancy in dates, the accountant and the employer stated they did not have personal knowledge of what day it went out.

The Court decided that the Appeal Board should be reversed and sustained the imposition of the penalty. The court stated:

> ". . . If it be assumed that the employer mailed the report during the month of July the proof is clear that it was never received by the Commissioner. Under the provisions of the statute in question the employer is required to furnish to the Commissioner certain reports upon demand including the quarterly report within twenty days of such demand. Failure to do so incurs the penalty which was incurred here."
>
> "The case of Matter of Wittner & Co. (269 A.D. 802; 294 N. Y. 647) does not sustain the respondent's position here. The facts in that case are inapplicable to the case before us."

Availability and Voluntary Election to Retire

In Appeal Board Case #26,540-51, it was held that a claimant who retired from employment, obtaining a pension must establish his bona fide return to the labor market by convincing proof in order to be eligible for benefits. A contention of a return to the labor market and application to a former employer without other independent efforts to secure employment was insufficient.

The Excess Profits Tax Exchange

Conducted by DAVID ZACK, C.P.A.

THIS column is a clearing house for questions, problems and comments regarding Excess Profits Taxes. Items of general interest will be published herein and full credit will be given all contributors unless they request otherwise. All inquiries and contributions should be addressed to:

Editor, The Excess Profits Tax Exchange
The New York Certified
Public Accountant
677 Fifth Avenue
New York 22, New York

E P Ceilings for Newly Incorporated Partnerships

Samuel A. Dyckman, C.P.A., submits a very thought-provoking question which focuses attention upon a possible loophole in an excess profits tax provision of the Revenue Act of 1951:

"The question has recently arisen in our office whether an old established partnership or proprietorship incorporated after July 1, 1945 can qualify under Sec. 430 (e) as a new corporation entitled to use the special ceiling rates in the computation of its maximum excess profits tax for its first five years of business. In determining a constructive date of commencement of business, subsection (2)(B)(i) refers to transactions described in Sec. 445(g). Sec. 445 defines a new corporation for purposes of computation of an alternative average base period net income, and removes from its scope as new corporations taxpayers which have acquired assets in specified transactions from other corporations. There is no prohibition in Sec. 445(g) proper of an acquisition of assets in a Sec. 112(b)(5) transfer from a partnership or proprietorship. However, all tax free transfers must be related to Part II and Sec. 461(d) of Part II does specify that for purposes of Sec. 445 an 'acquiring corporation' shall be considered as having been in existence during such time as its 'component corporation' was in existence. An 'acquiring corporation' is defined as one receiving properties in a Sec. 112(b)(5) exchange (Sec. 461(a)(1)(d)), while a 'component corporation' is held to mean both a partnership (Sec. 461(b)(5)) or a proprietorship (Sec. 461(f)) whose properties were acquired.

Where a partnership or proprietorship is incorporated, it would therefore appear that for purposes of Sec. 445, the taxpayer is constructively in existence during the existence of the transferor. But under Sec. 430(e), although there is a cross reference to tax free corporate transfers under 445(g), there is no cross reference to Part II. Nor have the Part II sections been modified under the Revenue Act of 1951 to define transfer corporations as including partnerships or proprietorships for purposes of computing the ceiling rates available to new corporations.

On the basis of the foregoing analysis, would you agree that taxpayers need not tack on the existence of their component partnerships or proprietorships under Sec. 430(e)?"

It would indeed seem that a successor to a component partnership or proprietorship incorporated tax-free pursuant to Section 112(b)(5) of the Internal Revenue Code need not tack

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on the life of the component partnership or proprietorship under Section 430(e) of the Internal Revenue Code. The excellent analysis of Section 445 (g) set forth by the questioner appears quite correct and the limitation set forth in Section 430(e)(2)(B)(iii) applies solely to Part IV situations which specifically excludes Part II transactions. Since a tax-free transfer from a proprietorship or partnership to a corporation is specifically encompassed by Part II, Section 430(e)(2)(B)(iii) would not apply to a Section 112(b)(5) transfer.

This conclusion certainly appears contrary to basic Congressional intent, but it seems to flow inescapably from the legislative language. It certainly seems anomalous that a taxable transfer encompassed by Part IV should result in a denial of the special tariff limitations set forth for new corporation in Section 430(e) while a corporation resulting from a tax-free exchange covered by Part II is permitted the preferred rates. However, be it accident or design, the law appears to be so.

Capitalization of Expenditures for Advertising or Promotion of Goodwill

In most cases, Section 451 of the Internal Revenue Code exacts an exorbitant price for the relief granted. The election to capitalize certain expenditures for advertising or the promotion of goodwill binds all base period years and requires the recomputation and payment of normal and surtax for those years. Any base period year affected by the recomputation which is barred by the statute of limitation is subjected to tax as an inconsistent position under Sec. 452 of the IRC. In addition, the election binds all excess profits tax years under the current Act for normal and surtax purposes, as well as excess profits tax purposes.

The capitalization of these specified expenditures denies a taxpayer any possibility of treating the item as an abnormal deduction under Section 433 (b)(9) of the Internal Revenue Code inasmuch as the expense is eliminated for income and excess profits tax purposes.

The election to capitalize certain advertising and promotion expenditures is irrevocable and academic in most cases inasmuch as it must be made within six months of the due date of the first excess profits tax return.

This relief section was intended primarily for taxpayers using the income method, but it also serves to increase equity capital for invested capital purposes.

AN ADIRONDACK VIEW

Ahead in 1952. From sources which have hitherto been found reliable, here is the low-down on the year:

1. Our longest business boom will continue to boom. I wonder what a boom really is and how much reality is down under the sudsy bubbles of inflation.
2. There will be larger defense spending. Perhaps we'd better build a better offense too.
3. New construction as a whole will be less than 1951. This must be the decrease in the butter of "guns and butter" we have heard so much about.
4. Public spending and retail trade will increase. This will relieve some retailers' shelves—and bank loans on floor plans.
5. Paper output for Government forms and reports will increase.
6. So the CPA Summary is—more forms, fewer houses.

LEONARD HOUGHTON,
Adirondack "Chapter"

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